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Tax Expenditures

1999

Canada

GOVERNMENT OF CANADA

TAX EXPENDITURES

1999

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Chapter 1

INTERPRETING TAX EXPENDITURES: A GUIDE

What is a Tax Expenditure?

Governments have a variety of economic and social objectives. One instrument to achieve these objectives is public spending. It has often been argued that governments have the flexibility to use tax concessions, as a substitute for direct public spending, to achieve the same objectives. Such tax concessions are generally referred to as tax expenditures.

Tax Expenditures Versus Tax Concessions

While all tax expenditures are tax concessions, it does not follow that all tax concessions are tax expenditures.

To estimate tax expenditures, one needs to determine whether a tax concession is a substitute for spending. There are a number of considerations in this regard that need to be taken into account.

- Although a tax concession is generally considered to be a deviation from a benchmark tax structure, no consensus exists as to what constitutes a benchmark tax structure. Hence, there is no general agreement on whether or not a specific item is a tax concession. For example, is the lowest 17-per-cent personal income tax rate in Canada a tax concession or is it part of the underlying tax structure? For the purpose of this report, this rate is considered a part of the underlying structure of the tax system.
- Difficulties also arise when trying to determine whether a tax concession is a substitute for direct spending. For example, the dividend tax credit simply offsets the tax paid at the corporate level to avoid double taxation, and hence should not be classified as a tax expenditure.

Naturally, given these difficulties, there is a large element of subjectivity in defining tax expenditures. As a result, international comparisons of tax expenditures are not very useful.

The Canadian Approach

The Canadian approach seeks to provide as much information as possible to the reader, without getting into a controversy as to whether or not an item is a tax expenditure. Consequently, any deviation from a narrowly defined tax structure is reported. This allows the reader to decide whether or not a particular tax concession qualifies as a tax expenditure. This information on deviations from the tax system is reported in two parts. The first includes a list of all items that could be considered to be tax expenditures under a very broad (and perhaps unrealistic) definition. The second consists of all other deviations from the tax system; these are reported as memorandum items.

International Comparisons

Relative to other countries, Canada has taken a broad approach to reporting tax expenditures.

In the United Kingdom, tax concessions are reported under three categories. The first category, structural relief, incorporates both tax concessions that are a fundamental part of the tax structure and those which simplify administration and compliance. In contrast, the second category, tax expenditures, consists of tax concessions which are considered alternatives to direct spending. The third category comprises those tax reliefs which contain elements of both structural reliefs and tax expenditures, and thus cannot be classified explicitly as either structural reliefs or tax expenditures. Thus, all tax concessions are reported, but direction is given to the reader as to the appropriate classification of each.

In the United States, the method of reporting tax expenditures is slightly different. The United States reports tax expenditures against two different tax structures: normal and reference law. The normal tax structure reflects a comprehensive income tax system. Under the normal tax structure, any deviation from the basic tax structure is reported as a tax expenditure. The reference law baseline, however, more closely reflects existing tax law. Under reference law, tax expenditures are limited to those deviations from the tax structure that serve program functions.

Caveats

Care must be taken in interpreting the estimates and projections of tax expenditures in the tables for the following reasons.

- Tax expenditures are values of tax revenues forgone to achieve a variety of economic and social objectives. Whether or not the magnitudes of tax expenditures are appropriate depends upon an evaluation of the social and economic policies that generated them. The values reported in the tables provide no information towards such an evaluation.
- Estimates of various tax expenditure items cannot be added together – this is because the cost of each tax expenditure is estimated separately, assuming that all other tax provisions remain unchanged.
- The estimates assume all other factors remain unchanged (i.e. there is no allowance for behavioural changes, consequential government policy changes or changes in aggregate economic activity in response to the change in the tax expenditure).
- In addition to these considerations, the projections are subject to forecast error and are "best efforts" which have no greater degree of reliability than the variables that explain them.

What's New in the 1999 Report?

Estimates and projections for the changes to both the tax expenditures and memorandum items proposed in the 1999 budget have been added, which are:

Personal income tax measures

- Extension to all taxpayers of the tax relief provided by the $500 supplement in the 1998 budget to the amounts used to determine basic personal tax credits.

- Increase by a further $175 the amount of income that can be received tax-free for all taxpayers.
  - With these increases, the basic personal amount will rise to $7,131 and the spousal and equivalent-to-spouse amount will rise to $6,055.
- Increases to the National Child Benefit (NCB) supplement under the Canada Child Tax Benefit (CCTB) based on the $850 million committed in the 1998 budget as the second federal contribution to the NCB. The maximum supplement amounts will be increased by $180 in July 1999 and a further $170 in July 2000. Moreover, to avoid increasing marginal tax rates, the phase-out range of the NCB supplement will be expanded from $25,921 to $27,750 in July 1999 and from $27,750 to $29,590 in July 2000.
- Provision of an additional $300 million in July 2000 to enhance the CCTB for modest- and middle-income families. This will be done through an increase in the income threshold at which CCTB base benefits start to be reduced from $25,921 to $29,590.
  - As a result of these changes, the maximum CCTB benefits will reach $1,975 for the first child and $1,775 for each additional child in the year 2000, representing a maximum benefit for a two-child family of $3,750, an increase of $700 since 1998 and $1,210 since 1996.
- Introduction of a relieving mechanism for the computation of tax on certain retroactive lump-sum payments.
- Expansion of the medical expense tax credit to include certain costs of group homes for disabled persons, certain therapies for disabled persons and tutoring and talking books for persons with learning disabilities.
- Allowance for registered retirement savings plan (RRSP) proceeds to be transferred tax-free on death to a financially dependent child or grandchild even where the annuitant has a spouse.

Business income tax measures

- Extension of the temporary capital tax surcharge on large deposit-taking institutions to October 31, 2000.
- Extension of the manufacturing and processing tax rate reduction to the electricity-generating sector.

Sales tax measures

- Elimination of the phase-in of a $105 supplement to the goods and services tax (GST) credit for single parents. Also, proposed administrative changes to improve the responsiveness of the credit to changes such as marriage breakdown or the birth of a child.

As usual, other minor changes have been made to provide information that was not previously available and to update or otherwise improve the descriptions of certain measures.

What is in the Report?

- Chapter 2 presents estimates of tax expenditures and memorandum items.
- Chapter 3 provides the methodology used to derive these estimates.
- Chapters 4 (personal income tax), 5 (corporate income tax) and 6 (GST) provide simplified descriptions of each tax expenditure and memorandum item, as well as information on the data sources and methodology used in constructing the estimates.

Chapter 2

Estimates and Projections

Tables 1 to 3 provide tax expenditure values for personal income tax, corporate income tax and the goods and services tax (GST) for the years 1994 to 2001. In the case of personal income tax, tax expenditures are grouped according to functional categories. This grouping into functional categories is not intended as a policy justification for the specific provisions nor is it the case that all tax measures fall neatly into one of the categories. The categories are provided solely for organizational purposes.

All estimates are reported in millions of dollars. The letter "S" indicates that the cost is less than $2.5 million while "n.a." signifies that data were not available. The inclusion in the report of items for which estimates are not available is warranted given that the report is designed to provide information on the type of assistance delivered through the tax system even if it is not always possible to provide a quantitative estimate. Work is continuing to obtain quantitative estimates where possible.

Table 1
*Personal income tax expenditures**

	Estimates			Projections				
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Culture and recreation								
Deduction for clergy residence	60	56	59	57	57	57	57	57
Flow-through of capital cost allowance (CCA) on Canadian films[1]	12	48	–	–	–	–	–	–
Deduction for certain contributions by individuals who have taken vows of perpetual poverty	S	S	S	S	S	S	S	S
Write-off of Canadian art purchased by unincorporated businesses	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assistance for artists	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deduction for artists and musicians	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of capital gains on gifts of cultural property	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education								
Tuition fee credit[2]	185	195	210	265	295	315	340	365
Education credit[3]	43	44	55	92	190	195	195	195
Education and tuition fee credits transferred[4]	205	215	260	315	320	340	360	390
Carry-forward of education and tuition fee credits[5]	–	–	–	–	10	25	40	50
Student loan interest credit[6]	–	–	–	–	120	135	150	160

* The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See pages 42-47 for a discussion of the reasons for this.

Personal income tax expenditures (cont'd.)

	Estimates			Projections				
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Registered education savings plans (RESPs)[7]	n.a.	n.a.	35	32	44	78	125	185
Exemption on first $500 of scholarship, fellowship and bursary income	6	6	6	6	6	6	6	6
Deduction of teachers' exchange fund contributions	S	S	S	S	S	S	S	S
Employment								
Deduction of home relocation loans	S	S	S	S	S	S	S	S
Non-taxation of allowances to volunteer firefighters[8]	4	4	4	4	–	–	–	–
Deduction for emergency service volunteers[8]	–	–	–	–	14	14	14	14
Northern residents deductions[9]	155	125	125	115	120	120	125	125
Overseas employment credit	30	31	44	36	37	37	37	37
Employee stock options[10]	56	74	125	195	130	135	140	145
Non-taxation of strike pay	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of salary through leave of absence/ sabbatical plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Employee benefit plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of certain non-monetary employment benefits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Family								
Spousal credit[11]	1,190	1,200	1,205	1,185	1,195	1,315	1,435	1,450
Equivalent-to-spouse credit[11]	470	470	470	475	480	510	540	550
Infirm dependant credit[12]	10	6	7	7	7	7	7	7

Personal income tax expenditures *(cont'd.)*

	Estimates			Projections				
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Caregiver credit[6]	–	–	–	–	120	125	125	125
Canada Child Tax Benefit[13]	5,275	5,240	5,215	5,315	5,550	6,010	6,525	6,820
Deferral of capital gain through transfer to spouse	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Farming and fishing								
$500,000 lifetime capital gains exemption for farm property[14]	470	275	325	320	310	310	310	310
Net Income Stabilization Account								
Deferral of tax on government contributions[15]	43	31	115	98	86	100	100	100
Deferral of tax on bonus and interest income	8	14	19	23	35	42	52	60
Taxable withdrawals	-15	-15	-35	-39	-69	-48	-48	-48
Deferral of income from destruction of livestock	S	S	S	S	S	S	S	S
Deferral of income from grain sold through cash purchase tickets[16]	31	19	6	-1	8	8	8	8
Deferral through 10-year capital gain reserve[16]	14	8	-2	6	6	6	6	6
Deferral of capital gain through intergenerational rollovers of family farms	n.a.	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Exemption from making quarterly tax instalments	n.a.	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Cash basis accounting	n.a.	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Flexibility in inventory accounting	n.a.	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Federal-provincial financing arrangements								
Quebec abatement	2,185	2,320	2,410	2,560	2,640	2,740	2,810	2,935
Transfers of income tax room to provinces	9,090	9,745	10,240	11,215	11,600	12,030	12,350	12,885

Personal income tax expenditures (cont'd.)

	Estimates			Projections				
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
General business and investment								
$100,000 lifetime capital gains exemption[17]	8,815	34	–	–	–	–	–	–
Partial inclusion of capital gains[18]	385	405	655	850	635	655	675	695
Deduction of limited partnership losses[16, 19]	295	195	205	195	210	210	210	210
Investment tax credits[16]	70	54	39	22	38	38	38	38
Deferral through five-year capital gain reserve[16]	-27	-6	12	-7	-7	-7	-7	-7
Deferral through capital gains rollovers	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral through billed-basis accounting by professionals	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deduction of accelerated tax depreciation[20]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
$1,000 capital gains exemption on personal-use property	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
$200 capital gains exemption on foreign exchange transactions	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Taxation of capital gains upon realization	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health								
Non-taxation of business-paid health and dental benefits[21]	1,270	1,440	1,490	1,605	1,665	1,715	1,745	1,765
Disability credit	275	270	265	270	275	275	280	285
Medical expense credit[22]	260	305	330	350	370	390	410	430
Medical expense supplement for earners[23]	–	–	–	24	40	40	40	40
Income maintenance and retirement								
Non-taxation of guaranteed income supplement and spouse's allowance benefits	260	285	300	305	310	315	320	325
Non-taxation of social assistance benefits[24]	705	635	560	510	490	490	490	490

Personal income tax expenditures (cont'd.)

	Estimates			Projections				
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Non-taxation of workers' compensation benefits[16, 25]	585	635	620	605	615	615	615	615
Non-taxation of amounts received as damages in respect of personal injury or death	20	19	18	17	18	18	18	18
Non-taxation of employer-paid premiums for group term life insurance of up to $25,000[26]	87	–	–	–	–	–	–	–
Non-taxation of veterans' allowances, civilian war pensions and allowances, and other service pensions (including those from Allied countries)[27]	6	4	4	S	S	S	S	S
Non-taxation of veterans' disability pensions and support for dependants	140	135	140	140	140	140	140	140
Treatment of alimony and maintenance payments[28]	260	250	250	250	250	250	250	250
Age credit	1,290	1,270	1,320	1,345	1,490	1,515	1,540	1,570
Pension income credit	325	350	365	385	390	400	405	415
Saskatchewan Pension Plan	S	S	S	S	S	S	S	S
Registered retirement savings plans								
Deduction for contributions	4,785	5,290	5,940	6,345	6,975	7,675	8,070	8,880
Non-taxation of investment income[29]	3,565	3,850	3,520	3,400	3,310	3,890	4,370	4,880
Taxation of withdrawals	-1,620	-1,750	-2,192	-2,510	-2,750	-3,020	-2,945	-3,230
Net expenditure[30]	6,730	7,390	7,270	7,235	7,535	8,545	9,495	10,530

Personal income tax expenditures (cont'd.)

	Estimates			Projections				
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Registered pension plans								
Deduction for contributions	4,890	4,925	4,930	4,980	5,030	5,080	5,150	5,200
Non-taxation of investment income[29]	9,540	10,040	9,020	8,095	7,335	7,985	8,675	8,880
Taxation of withdrawals	-4,010	-4,520	-4,905	-5,490	-6,150	-6,890	-7,800	-8,735
Net expenditure[30]	10,420	10,445	9,045	7,585	6,215	6,175	6,025	5,345
Deferred profit-sharing plans	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of RCMP pensions/compensation in respect of injury, disability or death[31]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of up to $10,000 of death benefits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of investment income on life insurance policies[32]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Small business								
$500,000 lifetime capital gains exemption for small business shares[16, 33]	1,725	590	475	875	645	645	645	645
Deduction of allowable business investment losses[16]	77	79	74	64	72	72	72	72
Labour-sponsored venture capital corporations (LSVCCs) credit[34, 35]	110	235	91	80	130	130	130	130
Deferral through 10-year capital gain reserve[16]	4	-2	-5	-1	-1	-1	-1	-1
Other items								
Non-taxation of capital gains on principal residences[36]								
Partial inclusion rate	1,795	1,085	1,245	1,270	920	905	905	905
Full inclusion rate	2,390	1,445	1,660	1,690	1,225	1,205	1,205	1,205

Personal income tax expenditures (cont'd.)

	Estimates			Projections				
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Non-taxation of income from the Office of the Governor General	S	S	S	S	S	S	S	S
Assistance for prospectors and grubstakers	S	S	S	S	S	S	S	S
Charitable donations credit[37]	900	940	1,090	1,265	1,305	1,350	1,385	1,425
Reduced inclusion rate for capital gains arising from certain charitable donations[38]	–	–	–	90	95	100	105	110
Gifts to the Crown credit[39]	21	34	28	15	25	25	25	25
Political contribution credit[16]	9	10	11	16	12	12	12	12
Retroactive lump-sum payments[40]	–	10	10	10	10	10	10	10
Non-taxation of income of Indians on reserves	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of gifts and bequests	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Memorandum items								
Non-taxation of lottery and gambling winnings[41]	960	1,155	1,380	1,440	1,475	1,510	1,560	1,610
Non-taxation of specified incidental expenses	6	6	5	5	5	5	5	5
Non-taxation of allowances for diplomats and other government employees posted abroad	8	9	8	8	8	8	8	8
Child care expense deduction[42]	305	365	420	480	560	565	570	575
Attendant care expense deduction	S	S	S	S	S	S	S	S
Moving expense deduction[16, 43]	64	61	64	62	73	73	73	73
Deduction of carrying charges incurred to earn income[16, 44]	540	645	590	540	600	600	600	600
Deduction of meals and entertainment expenses[45]	110	97	130	85	110	110	110	110
Deduction of farm losses for part-time farmers	48	52	52	51	51	51	51	51

Personal income tax expenditures (cont'd.)

	Estimates			Projections				
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Farm and fishing loss carry-overs[16]	9	10	10	13	11	11	11	11
Capital loss carry-overs[16]	87	89	160	115	115	115	115	115
Non-capital loss carry-overs[16]	74	86	100	89	89	89	89	89
Logging tax credit	S	S	S	S	S	S	S	S
Deduction of resource-related expenditures[46]	77	78	170	160	135	135	135	135
Deduction of other employment expenses	540	540	585	615	635	655	675	695
Deduction of union and professional dues	465	505	510	520	525	530	535	540
Employment insurance								
Employment insurance contribution credit	1,300	1,320	1,260	1,325	1,250	1,255	1,280	1,255
Non-taxation of employer-paid premiums	2,655	2,710	2,605	2,735	2,585	2,600	2,650	2,590
Canada and Quebec Pension Plans								
Canada and Quebec Pension Plan credit	1,055	1,135	1,195	1,315	1,590	1,775	2,020	2,290
Non-taxation of employer-paid premiums	1,360	1,465	1,545	1,685	1,730	2,090	2,335	2,660
Foreign tax credit[47]	220	280	300	320	345	365	390	410
Dividend gross-up and credit	645	730	815	880	945	1,010	1,075	1,140
Supplementary low-income credit[48]	–	–	–	–	140	150	–	–
Basic personal credit[49]	17,325	17,650	17,885	18,120	19,015	21,320	23,580	24,220
Non-taxation of capital dividends	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes

1 The increase in this tax expenditure in 1995 reflects increases in the average amount of CCA claimed and the number of individuals claiming CCA in that year. The flow-through of CCA on Canadian films is not available for taxation years later than 1995, and is replaced by a tax credit to producers.

2 The 1997 budget extended this credit to most mandatory ancillary fees imposed by post-secondary institutions, beginning in 1997.

3 The 1996 budget increased this credit from $80 to $100 per month, beginning in 1996. The 1997 budget increased this credit to $150 per month for 1997, and $200 per month thereafter. The 1998 budget proposed to allow part-time students to claim a part-time education amount of $60 per month.

4 The 1996 budget increased from $4,000 to $5,000 the limit on the transfer of these amounts, beginning in 1996. The increase in this tax expenditure in 1997 reflects a 50-per-cent increase in the average claim in that year, based on preliminary information.

5 The 1997 budget introduced this measure, effective for 1997 and subsequent years.

6 This measure was proposed in the 1998 budget.

7 The 1998 budget proposed to supplement annual contributions to RESPs with a 20-per-cent grant, the Canada Education Savings Grant, beginning in 1998. While this enhancement does not represent a tax expenditure, it increases the cost of the tax expenditure to the extent that it encourages participation in the RESP program. No information is available for years prior to 1996.

8 The 1998 budget proposed to replace the $500 tax-free allowance for volunteer firefighters with a deduction of up to $1,000 for emergency service volunteers. The tax expenditure estimate for the emergency service volunteer deduction includes claims by firefighters after 1997.

9 The higher level of the tax expenditure in 1994 reflects the fact that residents of communities who are no longer eligible for benefits following the reform of northern benefits were eligible for one-third benefits in 1994, and none thereafter.

10 The increase in this tax expenditure in 1996 reflects a 30-per-cent increase in the number of claimants and a 30-per-cent increase in the average claim in that year. The increase in this tax expenditure in 1997 reflects a 50-per-cent increase in the number of claimants, based on preliminary information.

11 The 1999 budget proposed to increase this tax credit by $675 for all taxpayers, beginning July 1, 1999.

12 The decline in this tax expenditure for 1995 reflects a 35-per-cent decrease in the number of claimants in that year. The 1996 budget increased the maximum credit per dependant from $270 to $400.

13 The 1996 and 1997 budgets increased this tax benefit. The 1998 and 1999 budgets proposed additional enrichments to this provision. Payments made between January and December of the year are reported.

14 The decline in this tax expenditure in 1995 reflects a 20-per-cent decrease in the number of claimants and a 25-per-cent decrease in the average claim in that year. The increase in this tax expenditure in 1996 reflects a 15-per-cent increase in the number of claimants in that year.

15 The high level of this tax expenditure in 1996 reflects special start-up payments to farmers in Saskatchewan in that year.

16 This tax expenditure is highly volatile. It is projected at its historical average.

17 The lifetime capital gains exemption for general property is not available for taxation years later than 1994. The tax expenditure for 1995 reflects late and adjusted elections filed in that year with respect to gains accrued up to February 22, 1994. The large value of this tax expenditure in 1994 reflects the special election to claim the exemption for eligible capital gains accrued up to February 22, 1994 on 1994 tax returns.

18 The increase in the value of this tax expenditure in 1996 reflects a 50-per-cent increase in the number of claimants partially offset by a 10-per-cent decrease in the average claim in that year. The increase in the value for 1997 reflects a 30-per-cent increase in the number of claimants in that year, based on preliminary information. However, projections are based on historical trends.

19 The decline in the value of this tax expenditure in 1995 reflects a 40-per-cent decline in the number of claimants in that year.

20 This tax expenditure includes the deduction of scientific research and experimental development expenditures. Data are not available to estimate this tax expenditure with precision.

21 The 1998 budget proposed to allow unincorporated owner-operators to deduct premiums for supplementary health care coverage against their business income to a maximum amount, beginning in 1998.

22 The 1997 budget broadened this credit to cover additional expenses, beginning in 1997. The 1999 budget proposed to further broaden this credit for the care and education of persons with disabilities, beginning in 1999.

23 This measure was introduced in the 1997 budget. The value of this tax expenditure in 1997 reflects preliminary information.

24 The decline in this tax expenditure in 1997 reflects preliminary information, suggesting lower levels in future years.

25 The increase in this tax expenditure in 1995 reflects a 10-per-cent increase in the number of claimants in that year.

26 These amounts became taxable after July 1, 1994.

27 The expected decrease in this tax expenditure is in line with the historical trend.

28 The 1996 budget eliminated the income inclusion for recipients of child support payments and disallowed the deduction to payers for agreements made after April 30, 1997.

29 Projected values for this tax expenditure are lower than those provided in last year's publication due to lower-than-expected interest rates in those years.

30 Net expenditure represents the total tax expenditure associated with this measure.

31 The amounts reported in previous years for this tax expenditure included taxable amounts and did not cover all non-taxable RCMP pensions. This tax expenditure cannot be estimated with precision.

32 Although this measure does provide tax relief for individuals, it is implemented through the corporate tax system. See under "Interest credited to life insurance policies" in the corporate income tax expenditure tables for an estimate of the value of this tax expenditure.

33 The decline in this tax expenditure in 1995 reflects a 50-per-cent decline in the number of claimants and a 15-per-cent decline in the average claim in that year. The decline in this tax expenditure in 1996 reflects a further 30-per-cent decline in the average claim, partially offset by a 15-per-cent increase in the number of claims in that year. The increase in this tax expenditure in 1997 reflects a 65-per-cent increase in the number of claims and a 10-per-cent increase in the average claim in that year, based on preliminary information.

34 The 1996 budget reduced this credit from 20 per cent to 15 per cent and the purchase amount eligible for the credit from $5,000 to $3,500 per year, for purchases made after March 5, 1996. The purchase amount eligible for the credit was increased to $5,000 in 1998, effective for 1998 and subsequent years.

35 The high value of this tax expenditure in 1995 reflects record sales of shares of LSVCCs for that year. The decline in the value of this expenditure in 1996 reflects a 30-per-cent decline in the number of claimants and a 45-per-cent decline in the average claim in that year. The value of this tax expenditure in 1998 is based on preliminary information of sales of shares of LSVCCs for that year.

36 The decline in this tax expenditure in 1995 and 1998 reflects declines in home values and home sales in these years. Overall, this tax expenditure is expected to remain below its 1994 value, reflecting projected home values and sales.

37 The 1994 budget lowered the threshold at which charitable donations begin to earn the 29-per-cent credit from $250 to $200. The 1996 and 1997 budgets further enriched this credit. The increase in the value of this tax expenditure in 1997 reflects a 20-per-cent increase in the average claim in that year, based on preliminary information.

38 This measure was introduced in the 1997 budget. The value of this tax expenditure in 1997 reflects preliminary information.

39 The increase in the value of this tax expenditure in 1995 reflects a 10-per-cent increase in the number of claimants and a 45-per-cent increase in the average claim in that year. The decrease in the value of this tax expenditure in 1997 reflects a 35-per-cent decrease in the number of claimants and a 15-per-cent decrease in the average claim in that year, based on preliminary information.

40 This measure was proposed in the 1999 budget, effective for qualifying retroactive lump-sum payments received after 1994.

41 This estimate assumes that the total amount of lottery and horse racing winnings would be included in income and be subject to tax. However, there is some uncertainty regarding the proper benchmark tax system in this area. For example, if the benchmark system included taxation of winnings, it would also have to include a deduction for the purchase cost of tickets. A threshold below which winnings would not be taxable may also be necessary, due to the large administrative cost of taxing very small prizes. In addition, proceeds from the sale of lottery tickets are an important source of funds for provincial governments and not-for-profit organizations. As a result, there is already an element of taxation to lottery and gambling proceeds. This estimate is therefore included as a memorandum item only.

42 The 1996 budget broadened eligibility criteria for claiming this deduction, beginning in 1996. The 1998 budget proposed to increase the maximum claim under this provision and to extend it to part-time students, beginning in 1998.

43 The 1998 budget proposed to enhance the moving expense deduction by including certain costs of maintaining a vacant former residence (including mortgage interest and property taxes) and other miscellaneous relocation expenses.

44 The increase in this tax expenditure in 1995 reflects a 10-per-cent increase in the average claim in that year. The decline in this tax expenditure in 1996 reflects a 15-per-cent decrease in the number of claimants in that year. The further decline in this tax expenditure in 1997 reflects a 10-per-cent decrease in the number of claimants in that year, based on preliminary information.

45 The deduction is limited to 50 per cent of eligible amounts incurred after February 1994. Amounts incurred earlier were deductible at 80 per cent.

46 The increase in this tax expenditure in 1996 reflects a 40-per-cent increase in the number of claimants, and a 55-per-cent increase in the average claim in that year.

47 The expected increase in this tax expenditure is in line with the historical trend.

48 This measure was proposed in the 1998 budget. The 1999 budget proposed to extend this measure to all taxpayers, effective July 1, 1999. This latter proposal would increase the tax expenditures associated with the basic personal credit and the spousal/equivalent-to-spouse credits and eliminate the supplementary low-income credit. The 1998 budget also proposed relief from the general surtax for low- and middle-income taxpayers while the 1999 budget extended this relief to all taxpayers. These proposals represent a change in the benchmark tax system, and consequently there is no associated tax expenditure.

49 The 1999 budget proposed to increase the basic personal credit by $675, effective July 1, 1999.

Table 2
Corporate income tax expenditures*

	Estimates		Projections[1]					
	1994[2]	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Tax rate reductions								
Low tax rate for small businesses	2,365	2,470	2,560	2,915	2,810	2,685	2,695	2,765
Low tax rate for manufacturing and processing[3]	1,005	1,520	1,315	1,535	1,480	1,415	1,420	1,460
Low tax rate for credit unions	38	42	42	46	47	47	48	50
Exemption from branch tax for transportation, communications, banking and iron ore mining corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemption from tax for international banking centres	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax credits								
Investment tax credits								
Scientific research and experimental development investment tax credit	885	900	930	955	980	1,010	1,035	1,065
Atlantic investment tax credit[4]	105	165	270	200	68	50	55	55
Special investment tax credit[5]	29	34	–	–	–	–	–	–
Small business investment tax credit[6]	84	–	–	–	–	–	–	–
Investment tax credits claimed in current year but earned in prior years[7]	555	615	420	430	440	450	460	470
Political contribution tax credit	S	S	S	S	S	S	S	S
Canadian film or video production tax credit[8]	–	9	34	35	37	38	40	41
Film or video production services tax credit[9]	–	–	–	S	55	57	59	60

* The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See pages 42-47 for a discussion of the reasons for this.

Table 2
Corporate income tax expenditures *(cont'd.)*

	Estimates		Projections					
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Exemptions and deductions								
Partial inclusion of capital gains	525	625	625	635	660	690	720	755
Royalties and mining taxes								
Non-deductibility of Crown royalties and mining taxes	-385	-310	-325	-325	-310	-350	-375	-375
Resource allowance	540	480	475	475	450	495	510	520
Earned depletion[10]	21	41	40	30	25	10	10	S
Deductibility of charitable donations	89	97	120	120	130	130	130	130
Deductibility of gifts to the Crown	5	3	5	3	3	3	3	3
Interest on small business financing loans	S	S	S	S	S	S	S	S
Non-deductibility of advertising expenses in foreign media	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of provincial assistance for venture investments in small business	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferrals								
Accelerated write-off of capital assets and resource-related expenditures[11]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Table 2
***Corporate income tax expenditures** (cont'd.)*

	Estimates		Projections					
	1994	1995	1996	1997	1998	1999	2000	2001
	($ millions)							
Allowable business investment losses[12]	22	24	25	25	30	30	35	35
Holdback on progress payments to contractors[13]	15	39	15	20	20	20	20	20
Available for use	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Capital gains taxation on realization basis	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Expensing of advertising costs	18	7	6	10	10	10	10	10
Deductibility of contributions to mine reclamation and environmental trusts	S	S	S	S	S	S	S	S
Deductibility of countervailing and anti-dumping duties[14]	–	–	–	–	n.a.	n.a.	n.a.	n.a.
Deductibility of earthquake reserves[15]	–	–	–	–	15	16	17	18
Cash basis accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Flexibility in inventory accounting	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deferral of income from grain sold through cash purchase tickets	13	7	S	7	7	7	7	7
Deferral of income from destruction of livestock	S	S	S	S	S	S	S	S
Deferral of tax from use of billed-basis accounting by professionals	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
International								
Non-taxation of life insurance companies' world income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exemptions from non-resident withholding tax[16]								
Copyright royalties[17]	23	57	60	63	66	69	72	76

Table 2
Corporate income tax expenditures *(cont'd.)*

	Estimates		Projections					
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Royalties for the use of, or right to use, other property[18]	49	51	150	160	165	175	185	190
Interest on deposits	400	440	435	465	490	470	480	495
Interest on long-term corporate debt	595	660	650	690	735	705	720	740
Dividends[19]	21	52	62	76	84	78	72	73
Management fees	16	17	18	19	19	20	21	23
Exemption from Canadian income tax of income earned by non-residents from the operation of a ship or aircraft in international traffic	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other tax expenditures								
Transfer of income tax room to provinces in respect of shared programs	560	695	720	860	815	775	790	820
Interest credited to life insurance policies	70	73	74	77	81	85	90	94
Non-taxation of registered charities and other non-profit organizations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Income tax exemption for provincial and municipal corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-taxation of certain federal Crown corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Excise tax transportation rebate[20]	S	–	–	–	–	–	–	–
Aviation fuel excise tax rebate[21]	–	–	–	n.a.	n.a.	n.a.	n.a.	–

Table 2

Corporate income tax expenditures *(cont'd.)*

	Estimates		Projections					
	1994	1995	1996	1997	1998	1999	2000	2001
	($ millions)							
Surtax on the profits of tobacco manufacturers[22]	-45	-59	-65	-65	-70	-70	-15	–
Temporary tax on the capital of large deposit-taking institutions[23]	–	-34	-51	-58	-63	-69	-75	–
Memorandum items								
Refundable Part I tax on investment income of private corporations[24]	855	1,045	1,215	1,135	1,150	1,200	1,250	1,290
Refundable capital gains for investment corporations and mutual fund corporations	170	150	180	190	195	205	215	225
Loss carry-overs[25]								
Non-capital losses carried back[26]	850	650	900	955	1,195	1,325	1,345	1,310
Non-capital losses applied to current year[27]	2,135	2,845	2,345	2,760	2,435	2,520	2,650	2,800
Net capital losses carried back[28]	84	68	81	82	100	110	120	120
Net capital losses applied to current year	130	125	160	155	135	140	150	155
Farm losses applied to current year[29]	8	19	13	13	14	14	15	15
Deductible meals and entertainment expenses[30]	240	190	200	205	210	220	225	235
Large corporations tax								
Threshold[31]	485	520	540	550	560	570	585	595
Exempt corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Patronage dividend deduction	145	215	220	250	235	235	235	235

Table 2
***Corporate income tax expenditures** (cont'd.)*

	Estimates		Projections					
	1994	1995	1996	1997	1998	1999	2000	2001
				($ millions)				
Logging tax credit[32]	89	75	30	28	30	30	30	30
Deductibility of provincial royalties (joint venture payments) for the Syncrude project (remission order)[33]	11	35	63	32	24	16	15	15
Deductibility of royalties paid to Indian bands	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Non-resident-owned investment corporation refund	60	105	105	120	130	145	160	170
Investment corporation deduction	S	S	S	S	S	S	S	S
Deferral of capital gains income through various rollover provisions	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Deduction for intangible assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax exemption on income of foreign affiliates of Canadian corporations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes

1 Unless otherwise indicated in the footnotes, changes in the projections from the figures in last year's edition of this document result from changes in the explanatory economic variables upon which the projections are based.

2 The 1994 figures are based upon final data and may differ from the figures in last year's edition of this document which were based on preliminary data.

3 The increase from 1994 to 1995 in the revenue cost of the low tax rate for manufacturing and processing (M&P) profits reflects both a decrease in the tax rate on M&P profits from 22 per cent to 21 per cent and an increase in the level of M&P profits. The decrease from 1995 to 1996 reflects a projected decrease in the level of M&P profits.

4 The projected cost of the tax expenditure for 1998 and beyond is lower because a large portion of this tax expenditure relates to the Hibernia offshore oil project, which has completed its investment phase. No new offshore projects have been included in the projections. The tax expenditure could be higher if a project were to proceed.

5 New investments did not earn this credit after December 31, 1994. Credits not claimed in 1994 and prior years may be carried forward. However, they are included in the investment tax credits claimed in a current year but earned in prior years.

6 New investments did not earn the small business investment tax credit after December 31, 1993. As a result, this credit could only be earned in the 1994 and previous taxation years. Unclaimed credits are carried forward and may be claimed in subsequent years. When claimed, these unused credits are included under investment tax credits claimed in a current year but earned in prior years.

7 All investment tax credits earned in previous years but not claimed until the current year are included under this item. Because this tax expenditure fluctuates significantly from year to year, the tax expenditure projections are based upon an average of the amounts of 1992 to 1995.

8 Taxation year 1995 is a transition year. Some films are financed by tax shelter deductions for accelerated capital cost allowance.

9 This measure was introduced in 1997.

10 Due to the elimination of the earned depletion allowance, there have been no additions to this tax expenditure pool since 1989. Amounts claimed in the current years relate to depletion earned in 1989 and prior years.

11 This tax expenditure consists of the fast write-off of certain capital assets, including capital equipment used for scientific research and experimental development, and of resource exploration and development expenditures and energy conservation and efficiency equipment. See text on page 88 for a further explanation of why no figures have been calculated.

12 The tax expenditure for allowable business investment losses fluctuates from year to year depending upon the amount of current year losses and the availability of income against which to apply these losses.

13 The amount of this tax expenditure can fluctuate significantly from year to year depending primarily upon the level of construction activity.

14 This measure was introduced in 1998.

15 This measure was introduced in 1998.

16 These estimates are based on the benchmark assumption that no behavioural response would occur after the hypothetical removal of existing withholding tax exemptions. This assumption is particularly difficult to sustain for this type of tax, as indicated in the text, which means that the amounts shown in the table should not be regarded as estimates of the revenue gain that would be realized from the hypothetical removal of the listed withholding tax exemptions.

17 The low level in 1994 is due to the low level of exempt payments made to non-residents that year. This can be expected on occasion since the events that trigger such payments will not necessarily occur on a regular basis.

18 The large increase from 1995 to 1996 can be attributed to protocol changes to the Canada-U.S. tax treaty.

19 The low level in 1994 is due to the low level of exempt payments made to non-residents that year. This can be expected on occasion since the events that trigger such payments will not necessarily occur on a regular basis.

20 This rebate was applicable to purchases of diesel and aviation fuel subject to federal excise tax during the 1991 and 1992 calendar years only.

21 This measure is effective for the years 1997 to 2000 inclusive.

22 This measure was introduced in 1994 and is scheduled to expire in 2000.

23 This measure was introduced in the 1995 budget and extended in the 1996, 1997, 1998 and 1999 budgets. The measure is scheduled to expire after October 31, 2000.

24 The increase over the 1994 to 1996 period results from an increase in the amount of investment income and the introduction of an additional refundable tax of 6⅔ per cent effective July 1, 1995.

25 The impact of loss carry-overs can fluctuate significantly from year to year depending upon the amount of current and prior years' losses and the availability of income against which to apply these losses.

26 The decrease in this amount from 1994 to 1995 results from a decrease in the amount of losses available for carry-back to reduce income of prior years.

27 The increase in this amount from 1994 to 1995 results from an increase in the amount of income against which to apply losses of prior years.

28 The decrease in this amount from 1994 to 1995 results from a decrease in the amount of losses available for carry-back to reduce income of prior years.

29 The increase in this amount from 1994 to 1995 results from an increase in the amount of income against which to apply losses of prior years.

30 The decrease in the tax expenditure for meals and entertainment expenses from 1994 to 1995 results from the decrease in the deductible portion of such expenses from 80 per cent to 50 per cent, effective after February 1994.

31 The large corporations tax rate increased to 0.225 per cent from 0.2 per cent, effective February 28, 1995. Therefore, the value of the exempt threshold was increased for taxpayers.

32 Projections for the 1996-2001 period reflect lower commodity prices for natural resources.

33 The amount of this tax expenditure can fluctuate significantly from year to year depending primarily upon profitability and capital expenditures. These two factors can change the payments made under the joint venture agreement with the Government of Alberta. The large decrease from 1996 to 1997 can be attributed to changes in the joint venture agreement implemented on January 1, 1997.

Table 3
GST tax expenditures*

	Estimates				Projections			
	1994	1995	1996	1997	1998	1999	2000	2001
	($ millions)							
Zero-rated goods and services								
Basic groceries	2,595	2,675	2,760	2,875	3,000	3,115	3,225	3,340
Prescription drugs	275	285	300	310	320	330	340	350
Medical devices	145	150	155	160	170	175	180	185
Agricultural and fish products and purchases	S	S	S	S	S	S	S	S
Certain zero-rated purchases made by exporters	S	S	S	S	S	S	S	S
Non-taxable importations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Zero-rated financial services	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax-exempt goods and services								
Long-term residential rent	1,450	1,500	1,555	1,600	1,655	1,700	1,735	1,785
Health care services	340	355	385	425	450	475	505	540
Education services (tuition)	340	350	370	395	410	430	455	480
Child care and personal services	175	180	185	200	210	215	230	240
Legal aid services	30	30	30	30	35	40	40	40
Ferry, road and bridge tolls	5	5	5	5	5	5	5	5
Municipal transit	50	50	45	45	50	50	55	55
Exemption for small business	105	105	110	120	125	125	130	130
Quick method accounting	130	135	150	160	165	170	175	180
Water and basic garbage collection services	80	85	90	90	95	95	95	100

* The elimination of a tax expenditure would not necessarily yield the full tax revenues shown in the table. See pages 42-47 for a discussion of the reasons for this.

Table 3
***GST tax expenditures** (cont'd.)*

	Estimates				Projections			
	1994	1995	1996	1997	1998	1999	2000	2001
	($ millions)							
Domestic financial services	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Certain supplies made by non-profit organizations	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Tax rebates								
Rebates for book purchases made by qualifying public institutions[1]	n.a.	n.a.	S	25	25	30	30	30
Housing rebates[2]	520	415	435	520	520	520	540	540
Rebates for foreign visitors on accommodations[3]	50	55	65	70	75	75	80	80
Rebates for municipalities[4]	530	565	540	560	560	560	560	560
Rebates for hospitals[4]	275	270	250	250	250	250	250	250
Rebates for schools[4]	290	300	285	290	290	290	290	290
Rebates for universities[4]	120	120	115	115	115	115	115	115
Rebates for colleges[4]	50	55	50	45	45	45	45	45
Rebates for charities	135	140	140	140	145	150	155	160
Rebates for non-profit organizations	70	70	65	60	65	65	70	70
Tax credits								
Special credit for certified institutions	n.a.	n.a.	n.a.	–	–	–	–	–
The GST credit[5]	2,785	2,820	2,850	2,895	2,860	2,850	2,830	2,810

Table 3
***GST tax expenditures** (cont'd.)*

	Estimates				Projections			
	1994	1995	1996	1997	1998	1999	2000	2001
	($ millions)							
Memorandum items								
Meals and entertainment expenses[6]	115	100	105	100	105	110	115	115
Rebates to employees and partners	70	60	70	70	75	75	80	80
Sales of personal-use real property	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes

1 This measure was introduced in October 1996.

2 The sharp decline in 1995 reflects the significant weakness in residential construction in that year.

3 Estimates of this tax expenditure were derived as part of a review of the Visitors' Rebate Program conducted during 1997.

4 Since the value of this tax expenditure is influenced by provincial budgetary decisions, the projected value of the tax expenditure for the relevant years is simply the value estimated for 1997.

5 The decline in the GST credit between 1998 and 2001 reflects actual and anticipated growth in nominal personal income. It should be noted that the 1998 figure is based on actual data provided by Revenue Canada.

6 The numerical approach used to derive the tax expenditure figures is tightly integrated with the tax expenditure estimates reported for the personal and corporate tax system.

Chapter 3

Framework and Methodology

Introduction

The purpose of this report is to serve as a source of information for parliamentarians, government officials and others who wish to analyze Canada's federal income tax system and the goods and services tax (GST). It is also an important input into the process of evaluating the operation of these tax systems. However, it should be emphasized that this report itself does not attempt to make judgments about either the appropriateness of government policy objectives or the effectiveness of the various tax provisions in achieving those objectives.

The principal function of taxes is to raise the revenues necessary to finance important public programs. This tax revenue is often raised in a way which, at the same time, implements government policy objectives by providing assistance or incentives to particular groups of individuals, businesses or certain types of activities. These measures, which can take the form of tax exemptions, deductions, rate reductions, rebates, deferrals or credits, are typically referred to as tax expenditures. This document provides historical estimates, based on a sample of taxpayer returns, of the cost of these items for the last years for which data are available. In the case of the personal income tax system, these are 1994, 1995 and 1996. For the corporate income tax system, they are 1994 and 1995. The GST estimates are for the years 1994 to 1997. In addition, this document provides projections of these tax expenditures, beyond the last historical year, to 2001.

In order to identify tax expenditures, it is necessary to establish a "benchmark" tax structure which does not contain any preferential tax provisions. Tax expenditures are then defined as deviations from this benchmark. It is important to recognize that reasonable differences of opinion exist as to the definition of the benchmark tax system, and hence what constitutes a tax expenditure. For example, child care expenses could be considered to be a cost of earning income and therefore part of the benchmark tax system; if not, then tax assistance for child care expenses would be a tax expenditure.

This report takes a broad approach – only the most fundamental structural elements of each tax system are considered to be part of the benchmark. By defining the benchmark in this manner, many tax provisions are treated as tax expenditures. This approach provides information on a full range of measures, and so allows readers who take a different position as to the appropriate benchmark system to construct their own list of tax expenditures.

In keeping with this objective of providing as much information as possible, the document identifies several tax provisions that are not generally considered to be tax expenditures even though they reduce the amount of revenue collected. These measures are denoted as "memorandum items" and have been included simply to provide additional information. Three types of memorandum items are included.

- Measures that are considered to be part of the benchmark system. The dividend tax credit, for example, reduces or eliminates the double taxation of income earned by corporations and distributed to individuals through dividends.
- Measures where there may be some debate over whether the item should be considered to be a tax expenditure. The cost of business-related meals and entertainment, for example, may be considered to be an expense incurred in order to earn income (and therefore be part of the benchmark) or may be considered to provide a benefit (and therefore constitute a tax expenditure).
- Measures where the available data do not permit separation of the tax expenditure component from the portion which is essentially part of the benchmark tax system. For example, a portion of tax-free allowances for Members of Parliament (MPs) is used to cover legitimate employment expenses (and is therefore part of the benchmark for the income tax system) while the rest may be used for personal consumption (and is therefore an income tax expenditure). Since it is not possible to distinguish between these two elements, the non-taxation of such allowances is included as a memorandum item.

The federal and provincial income tax and sales tax systems interact with each other to various degrees. As a result, changes to tax expenditures in the federal system may have consequences for provincial tax revenues. In this publication, however, any such provincial effects are not taken into account – that is, the tax expenditure estimates are purely federal in nature.

The remainder of this chapter discusses the tax expenditure concept in order to facilitate understanding of the quantitative estimates. It also discusses the calculation and interpretation of the costs of tax expenditures, including key assumptions used in the analysis. Chapter 2 presented estimates of the costs of tax expenditures and memorandum items in the personal and corporate income tax systems and the GST.

Simplified descriptions of each tax expenditure as well as information on data sources and methodology used in constructing the estimates are presented in Chapter 4 (personal income tax), Chapter 5 (corporate income tax) and Chapter 6 (GST).

What are tax expenditures?

Tax expenditures are those tax incentives that are used as alternatives to direct government spending for achieving government policy objectives.

While there is agreement on this conceptual definition of a tax expenditure, difficulties arise in making this definition operational. There is no widely accepted operational methodology for estimating tax expenditures. A range of methodologies exists internationally, some restrictive, others very broad. The broadest of the available options is to estimate tax expenditures as all deviations from a benchmark tax system. Typically, these deviations take the form of exemptions, deductions, rate reductions, rebates, credits or deferrals. It is to be expected that such a wide interpretation will produce a list which includes many items that are not tax expenditures. It is this interpretation of tax expenditures that is used here to provide as much information as possible on deviations from the benchmark tax system.

Elements of Tax Expenditures in the Personal and Corporate Income Tax Systems

The benchmark for the personal and corporate tax systems includes the existing tax rates and brackets, unit of taxation, time frame of taxation, treatment of inflation for calculating income and those measures designed to reduce or eliminate double taxation.

The definition of income is crucial in determining what constitutes a tax expenditure. Tax provisions that provide for the deduction of current costs incurred to earn income are considered to be part of the benchmark system and are therefore not considered to be tax expenditures. For example, the deductibility of labour costs or economic depreciation of business assets in determining business income would not be considered a tax expenditure.

It is important to emphasize that the definition of the benchmark tax structure, and hence the identification of tax expenditures, is subjective. Reasonable differences of opinion may exist as to the interpretation and categorization of tax measures. For example, employment insurance (EI) premiums paid by an employee could be viewed either as an expense of earning income or as a tax used to finance an income transfer to the unemployed. From the first perspective, the current system of providing employees a tax credit for contributions would not be a tax expenditure. The credit for EI premiums merely recognizes an expense of earning income and, hence, is part of the benchmark tax structure. On the other hand, one could argue that the tax credit for EI premiums represents a tax expenditure because the taxes paid by taxfilers are generally not deductible against personal income taxes. For this reason the tax treatment of EI premiums is reported as a memorandum item. Measures such as these which are subject to debate are discussed on an individual basis in Chapters 4 and 5.

The following provides a more detailed discussion of the features of the benchmark for both the personal and corporate tax systems.

(1) Tax rates and income brackets

For the personal income tax system, the existing rate structure, including surtaxes, is taken to be part of the benchmark system. The basic personal credit is also treated as part of this structure since it is universal in its application and can be viewed as providing a zero rate of tax up to an initial level of income. However, the cost of this credit is included as a memorandum item.

With respect to the corporate income tax system, effective after February 27, 1995, the basic federal corporate tax rate is 29.12 per cent including the surtax but after the provincial abatement. Provisions that reduce this tax rate for certain types of activities or corporations are regarded as tax expenditures. These include the lower tax rate for manufacturing and processing profits and the lower tax rate for small business profits; the latter is available on the first $200,000 of active business income earned by most Canadian-controlled private corporations (CCPCs). The large corporations tax, levied at the existing rate, is also considered to be part of the benchmark tax system.

(2) Tax unit

Personal income taxes in Canada are based on individual income. Consequently, the individual is taken as the benchmark tax unit for the purposes of identifying tax expenditures in this report. This choice leads to the classification of the various provisions related to dependants, such as the spousal credit, as tax expenditures.

The choice of the appropriate unit for the corporate income tax benchmark system raises a number of conceptual issues. There is a wide range of possible tax units, including the establishment or activity unit within a corporation, the single legal corporate entity and the consolidated group of related corporations. The present income tax system contains elements of all these approaches. For example, the view that the activity unit is the appropriate unit of taxation is consistent with the “at-risk” rules, which restrict the amount of investment tax credits and business losses that may be flowed out to limited partners. The view that the single legal corporate entity is the relevant tax unit is supported by the fact that income from one part of a business can be offset by other business losses within the same corporation, whereas losses by one corporation may not generally be used against the income of another corporation in the group. Other provisions in the current tax system allow corporate groups to reorganize their corporate structures without triggering any capital gains or recaptured depreciation. These rollover provisions lead to a deferral of capital gains and recaptured depreciation, which would be appropriate if the taxation unit is the consolidated group of related corporations. On balance, the view most closely related to the existing system is that of the single legal corporate entity. For this reason, the single corporation is adopted as the benchmark tax unit, together with the availability of various rollover provisions which permit the deferral of capital gains when a corporate structure is changed.

(3) Taxation period

In this document, the benchmark taxation period for the personal income tax system is the calendar year. Accordingly, any measures that provide deferrals of taxable income to a subsequent year are considered to be tax expenditures. For example, farmers are permitted to defer the receipt of income from the sale of grain through the use of special cash purchase tickets, and this is listed as a tax expenditure.

The benchmark taxation period for the corporate income tax system is the fiscal year. As with the personal income tax system, deferrals, such as the accelerated write-off of capital assets, are considered to be tax expenditures.

A strict application of the annual taxation period would imply that measures which provide for the carry-over of losses to other years would be tax expenditures. However, the relatively cyclical nature of business and investment income suggests that such income should be viewed over a number of years. Consequently, carry-overs of business and investment losses are treated as part of the benchmark tax system in this report. Estimates of the cost of these provisions are provided in the memorandum items section.

(4) Treatment of inflation

Both the personal and corporate income tax systems are based on nominal income with a number of provisions that account for the impact of inflation. Nominal income is therefore taken as the appropriate basis for the benchmark tax system. Consequently, special measures, such as the partial exclusion of capital gains from taxable income, which may serve to recognize inflation, are identified as tax expenditures.

(5) Avoidance of double taxation

Conceptual difficulties arise in deciding whether certain provisions which reduce or eliminate double taxation should be considered as tax expenditures.

For example, regarding the personal and corporate income tax systems as completely separate would suggest that the dividend tax credit is a tax expenditure. However, the credit is an essential feature of the overall (i.e. both corporate and personal) income tax structure and serves to eliminate or reduce double taxation. In its absence, income earned through corporations would be taxed twice, once in the corporation and once at the personal level. For this reason, the dividend tax credit is not considered to be a tax expenditure.

Similarly, the non-taxation of intercorporate dividends is designed to ensure that income already taxed in one corporation is not taxed again upon receipt of a dividend by another corporation. Without this exemption, double taxation would occur and the corporate income tax system would not be neutral across organizational structures. For example, consider a single corporation that currently operates as a number of divisions. Now suppose it reorganizes into a holding company with wholly owned subsidiaries instead of divisions. The profits from the subsidiaries flow to the

holding company through intercorporate dividends. If these dividends were subject to taxation at both the subsidiary and the holding company levels, double taxation would occur. Consequently, the exemption of intercorporate dividends is not considered a tax expenditure.

Similar reasoning applies to the tax exemption on income of foreign affiliates of Canadian corporations. Canada either exempts from Canadian corporate income tax certain dividend income paid by foreign affiliates or it provides a foreign tax credit for income taxes paid in the other country. In either case, the intention is to ensure that income is not subject to double taxation (i.e. once in the country of residence of the foreign affiliate and once again in Canada when the dividends are paid out). A further discussion of this topic, and the possible benchmarks that could be considered, is contained in Chapter 5.

Information on some of these measures that provide relief from double taxation is provided in the appropriate memorandum sections of this report.

The benchmark for the income tax system

The definition of the benchmark tax structure, and hence the identification of tax expenditures, is subjective. The essential features of the benchmark for income taxes in this report are:

Personal income tax

- *the existing tax rates and income brackets are taken as given;*
- *the tax unit is the individual;*
- *taxation is imposed on a calendar year basis;*
- *nominal income (i.e. no adjustment for inflation) is used in defining income; and*
- *structural features of the overall tax system, such as the dividend gross-up and credit, are incorporated.*

Corporate income tax

- *the existing general tax rate is taken as given;*
- *the tax unit is the corporation;*
- *taxation is imposed on a fiscal year basis;*
- *nominal income (i.e. no adjustment for inflation) is used in defining income; and*
- *structural features of the overall tax system, such as the non-taxation of intercorporate dividends, are incorporated.*

Tax Expenditures in the Goods and Services Tax[1]

The benchmark system used to analyze the GST is a broadly based, multi-stage, value-added tax collected according to the destination principle and using a tax credit mechanism to relieve the tax in the case of business inputs. The following provides a more detailed discussion of the features of the GST benchmark.

(1) Multi-stage system

The main structural elements of a multi-stage consumption tax are taken to be part of the benchmark. Under the multi-stage system, tax is applied to the sales of goods and services at all stages of the production and marketing chain. At each stage, however, businesses are able to claim tax credits to recover the tax they paid on their business inputs. In this way, the tax system has the effect of applying the tax only to the value added by each business. Since the only tax that is not refunded is the tax collected on sales to final consumers, the tax rests ultimately on final consumption.

(2) Destination-based

The benchmark system applies tax only to goods and services consumed in Canada. Accordingly, the tax applies to imports as well as domestically produced goods and services. Exports are not subject to the tax.

(3) Single tax rate

The benchmark system has only one tax rate. This rate corresponds to the statutory rate of 7 per cent. As a result, GST provisions that depart from this single rate are considered to be tax expenditures.

(4) Taxation period

The benchmark taxation period is the calendar year.

(5) Constitutional provisions for government sectors

Section 125 of the *Constitution Act, 1867*, provides that "no land or property belonging to Canada or any province shall be liable to taxation." This means that neither the federal nor the provincial governments (or their Crown agents) are liable to taxation by the other. Accordingly, constitutional immunity from taxation is recognized as part of the benchmark system for the GST.

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[1] It should be noted that this analysis deals only with the GST and not with other commodity taxes (e.g. excise taxes). The exclusion of these other commodity taxes recognizes the inherent conceptual difficulties of defining an appropriate benchmark system in the context of a tax which is applied to a specific commodity. Work is continuing on defining an appropriate benchmark system which would allow the future measurement of the associated tax expenditures.

The benchmark also recognizes that the federal and provincial governments have taken steps to simplify the operation of the tax for transactions involving government sectors.

- The federal government decided to apply the GST to purchases by federal departments and Crown corporations in order to keep the tax as simple as possible for vendors. As a result, the GST and the benchmark system treat federal Crown corporations in the same manner as any other business entity.
- By virtue of Section 125, provincial governments and Crown agents are not liable to pay the GST on their purchases. However, the federal government and most provinces have entered into Reciprocal Tax Agreements. These agreements specify situations in which each level of government agrees to pay the sales taxes of the other. Generally, this involves applying tax to purchases made by Crown corporations. As a result, provincial Crown corporations are treated like any other business entity in the benchmark system.

Unlike provincial governments, municipalities are liable to pay the GST. Therefore, the benchmark system considers them as paying tax on their purchases. Universities, colleges, schools and hospitals are also considered to pay tax on their purchases. The GST and the benchmark generally treat these sectors as final consumers – that is, they pay GST on their purchases, they do not claim input tax credits and they do not collect GST on their sales.

The only exception to this benchmark treatment arises from the fact that municipalities, universities, colleges, schools and hospitals engage in certain commercial activities analogous to those provided in the private sector. For example, some municipalities operate golf courses. Such commercial activities are taxable under the GST, and the GST paid on associated inputs can be claimed as input tax credits.

The benchmark for the goods and services tax

The essential features are:

- *basic structural features of a broadly based, multi-stage tax system;*
- *destination approach;*
- *7-per-cent rate;*
- *calendar year basis for the taxation period; and*
- *recognition of constitutional provisions for government sectors.*

Types of GST tax expenditures

Comparing the actual structure of the GST to the benchmark system, it is possible to identify four types of tax expenditures:

- zero-rated goods and services;

- tax-exempt goods and services;
- tax rebates; and
- tax credits.

(1) Zero-rated goods and services

Under the GST, certain categories of goods and services are considered to be taxed at a "zero" rate, rather than at the general tax rate of 7 per cent. Vendors do not charge GST on their sales of zero-rated goods and services (whether these sales are to other businesses or to final consumers). However, vendors are entitled to claim input tax credits to recover the GST they paid on inputs used to produce zero-rated products. As a result, zero-rated goods and services are tax-free.

One category of zero-rated sales is basic groceries – i.e. foods intended to be prepared and consumed at home. Other categories of zero-rated sales include prescription drugs, medical devices and most agricultural and fish products.

(2) Tax-exempt goods and services

Some types of goods and services are exempt under the GST. This means that the GST is not applied to these sales. Unlike zero-rated goods and services, however, vendors of exempt products are not entitled to claim input tax credits to recover the GST they paid on their inputs to these products.

Examples of tax-exempt goods and services include long-term residential rents, most health and dental care services, day-care services, most sales by charities, most domestic financial services, municipal transit and legal aid services.

(3) Tax rebates

Certain sectors are eligible for rebates on a portion of the GST paid on inputs. For example, there are rebates for schools, universities, hospitals and municipalities. To the extent that these sectors make taxable sales, they can claim input tax credits to recover the tax they paid on inputs to these sales. Where they provide tax-exempt services, however, they are eligible to receive rebates for only a portion of the GST paid on their inputs to these services. These rebates ensure that these institutions do not bear a greater tax burden on their purchases under the GST than they would have under the manufacturers' sales tax, which the GST replaced. This treatment constitutes a tax expenditure because, under the benchmark system, these institutions are considered to be final consumers.

Other examples of tax rebates include the rebates for charities, substantially government-funded non-profit organizations, newly built housing and book purchases made by qualifying institutions. Also, foreign visitors to Canada are able to claim a rebate for the GST they pay on hotel accommodation and on goods they take home. Only the rebate for hotel accommodation is considered to be a tax expenditure, however, because goods taken home by foreign visitors are effectively exports which are not taxable under the benchmark system.

(4) GST credit[2]

To ensure that the GST system is fair, a GST credit is provided through the personal income tax system to single individuals and families with low and moderate incomes. The credit is paid by cheque four times a year in equal instalments. The total amount of the credit people receive depends on family size and income, and it is calculated annually based on information provided in personal income tax returns.

> ***GST tax expenditures:***
>
> - *zero-rated goods and services;*
> - *tax-exempt goods and services;*
> - *tax rebates; and*
> - *tax credits.*

Memorandum items for the goods and services tax

As indicated earlier, some tax measures are presented as memorandum items even though they are not generally considered to be tax expenditures. For example, the refund of GST for certain employees' expenses is included as a memorandum item.

Many employees, such as commission salespeople, incur significant expenses in the course of carrying out their duties. Examples include restaurant meals and automobile expenses. Often, such expenses are not reimbursed by employers except indirectly through the salaries and commissions paid to employees. Since employees are not considered to be carrying on a commercial activity, they are not able to claim input tax credits for the GST they paid on these expenses. However, employees can receive a refund of the GST paid on those employment expenses that are deductible for income tax purposes. The refund of GST paid on employees' personal consumption expenses would constitute a tax expenditure. However, it is not possible to determine exactly what portion of these expenses should be considered personal consumption. Therefore, the refunds of GST paid on employees' expenses are reported as memorandum items. The memorandum items for the GST are discussed in more detail in Chapter 6.

Calculation and Interpretation of the Estimates

The estimates indicate the annual cash-flow impact to the government of each particular measure, and not their long-run or steady-state revenue cost, subject to the following limitations:

- all measures are evaluated independently; and
- all other factors remain unchanged.

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[2] It should be noted that there was a small business transitional credit which accompanied the introduction of the GST. This temporary measure provided a one-time credit of up to $1,000 to GST registrants whose taxable sales did not exceed $500,000 in their first full quarter of 1991 or in any three-month period beginning in 1990.

These methodological distinctions are important and have implications for the interpretation of the estimates. These concepts are discussed in further detail below.

Independent estimates

The estimate of the cost of each tax expenditure is undertaken separately, assuming that all other tax provisions remain unchanged. An important implication of this is that the estimates cannot be meaningfully aggregated to determine the total cost of a particular group of tax expenditures or of all tax expenditures combined.

As explained in more detail in the following paragraphs, this restriction arises from the fact that:

- the income tax rate structure is progressive; and
- tax measures interact with one another.

Progressive income tax rates

The combined effect of claiming a number of income tax exemptions and deductions may be to move an individual to a lower tax bracket than would have applied had none of the tax measures existed. To the extent that this occurs, aggregation of the individual estimates may under-represent the "true" cost to the federal government of maintaining all of them. For example, consider a taxpayer whose taxable income was $1,000 below the level at which he or she would move from the 17-per-cent into the 26-per-cent tax bracket. Imagine that this taxpayer arrives at this level of taxable income by using two tax deductions of $1,000 each (e.g. home relocation loan and registered retirement savings plan (RRSP) contribution). Eliminating either deduction by itself would increase taxable income by $1,000 and the taxpayer's federal tax liability by $170. Eliminating both measures simultaneously, however, would not raise the tax liability by $170 + $170, but rather by $170 + $260.

Aggregating the individual estimates for these two items would provide a misleading impression of the revenue impact of eliminating both of them. Therefore, the estimates in this document cannot be meaningfully aggregated to determine the total cost of a particular group of tax expenditures or of all tax expenditures combined.

While there is only one statutory tax rate for corporations, the small business deduction creates a de facto progressive tax rate schedule for some corporations. In this way, the above argument is valid for the corporate income tax system as well, although the effect is not as large as for personal income taxes.

Interaction of tax measures

As noted above, the estimates are computed one at a time, assuming all other provisions remain unchanged. Given that tax provisions sometimes interact, the total cost of a group of tax expenditures calculated individually may differ from the dollar value of calculating the cost of the same group of tax expenditures concurrently. This is because adding the independently

estimated costs of the tax provisions would result in double counting and so would not provide an accurate measure of the revenue which would be generated by simultaneously altering a group of measures.

For example, consider the non-taxation of veterans' allowances, which reduces the recipient's net income. Many measures, such as the medical expense credit, are calculated on the basis of net income. Thus, the reported estimate for the non-taxation of veterans' allowances represents not only the direct impact on government receipts of not taxing the allowances, but also the indirect impact of the change on the cost of other tax measures (such as the medical expense credit) which depend on net income.

Since estimates for GST tax expenditures are made using the same methodological approach as for income taxes, they too cannot be aggregated because they may interact. The following discussion of hospital rebates and zero-rating of prescription drugs illustrates the differences between independent and concurrent estimates for these two provisions.

- Eliminating hospital rebates: If hospital rebates were eliminated, hospitals would no longer be able to recover 83 per cent of the GST they pay on their purchases.[3] However, they could continue to purchase prescription drugs on a tax-free basis because these drugs are zero-rated. The estimate for hospital rebates recognizes that the rebate would not have been claimed in respect of zero-rated prescription drugs.
- Eliminating the zero-rating of prescription drugs: If prescription drugs were taxed at the GST rate of 7 per cent, then hospitals would pay the tax on their drug purchases but recover 83 per cent of the tax through the rebate system. Therefore, the estimate for the zero-rating of prescription drugs is calculated as net of the expected increase in the payment of hospital rebates.
- Eliminating the two measures concurrently has a revenue impact greater than the sum of the independent estimates because the GST would be payable on prescription drugs, and hospitals would be unable to claim a rebate for these purchases.

[3] Most services provided by hospitals are exempt from the GST. This means that no tax is charged on these services but input tax credits cannot be claimed to recover the tax paid on inputs. However, hospitals are able to claim a rebate of 83 per cent of the GST paid on the inputs they use to provide exempt services.

Aggregation of estimates

The estimates for individual tax expenditures cannot be added together to determine the cost of a group of tax expenditures. There are two reasons for this:

- *the simultaneous elimination of more than one income tax expenditure would generate different estimates because of progressive income tax rates; and*
- *given the interaction of certain tax measures, the revenue impact of eliminating two or more measures simultaneously would differ from taking the independently estimated numbers published in this document and simply aggregating them.*

All other factors remain unchanged

The estimates in this report represent the amount by which federal tax revenues were reduced due to the existence of each preference assuming that all other factors remain unchanged.

In order to evaluate the extent of the revenue reduction, the approach taken here is to recalculate federal revenues assuming the measure in question has been eliminated. The difference between this recalculated figure and actual revenues provides the quantitative estimate of the cost of the tax expenditure.

The assumption that all other things remain the same means that no allowance is made for: (1) behavioural responses by taxpayers; (2) consequential government policy changes; or (3) changes in tax collections due to altered levels of aggregate economic activity which might result from the elimination of a particular tax measure (further detail is provided below). Incorporating these factors would add a large subjective element to the calculations.

(1) Absence of behavioural responses

In many instances, the removal of a tax expenditure would cause taxpayers to rearrange their affairs to minimize the amount of extra tax they would have to pay, perhaps by making greater use of other tax measures. Therefore, the omission of behavioural responses in the estimating methodology generates cost estimates which may exceed the revenue increases that would have resulted if a particular provision had been eliminated.

As one example, consider the case of the deduction for RRSP contributions. Eliminating this provision would result in the amount of additional federal revenue indicated in the report only if the contributions were not directed to an alternative tax-preferred form of saving. However, the absence of the RRSP deduction might encourage individuals to place their funds instead in some other tax-favoured instrument, such as shares in a labour-sponsored venture capital corporation.

If such a response did occur, eliminating the RRSP deduction would result in a smaller increase in revenues than that indicated.

The effects of this assumption can also be illustrated for the GST by considering the housing rebate. Homeowners are eligible for a rebate of the GST they pay on the purchase of new houses. If this rebate were eliminated, the price of new houses would increase relative to the price of used houses. This, in turn, might reduce the demand for new houses while increasing the demand for used houses (which are tax exempt). Since the dynamics of the housing market are not taken into account, the revenues obtained by eliminating the housing rebate could actually be lower than the indicated estimate.

(2) Consequential government policy changes

The estimates ignore transitional provisions that might accompany the elimination of a particular measure and take no account of other consequential changes in government policy. For example, if the government were to eliminate a particular tax deferral, it could require the deferred amount to be brought into income immediately. Alternatively, it might prohibit new deferrals but allow existing amounts to continue to be deferred, perhaps for a specified period of time. The estimates in this report do not provide for any such transitional relief.

Similarly, the estimates make no allowance for consequential government policy changes. For example, if capital gains on owner-occupied housing were made taxable under the personal income tax system, an argument could be made that the cost of maintenance should be deductible in the same way as other investment expenses. Furthermore, it may not be possible to track and assess small gambling winnings. This may mean that a threshold under which winnings would be non-taxable would be required. However, in calculating the cost of providing the exemption for lottery winnings, no allowance is made for such hypothetical consequential government policy changes.

(3) Impact on economic activity

The estimates do not take into account the potential impact of a particular tax provision on the overall level of economic activity and thus aggregate tax revenues. For example, although eliminating the low corporate tax rate for manufacturing and processing could generate a significant amount of revenue for the government, the amount of manufacturing activity could decline, resulting in possible job losses, a reduction in taxable income and, hence, a reduction in the aggregate amount of tax revenue collected. Furthermore, the derivation of the estimates does not include speculation on how the government might use the additional funds available to it and the possible impacts this could have on other tax revenues.

How to interpret the estimates

Each estimate in this report represents the amount by which federal tax revenues were reduced due to the tax expenditure assuming that all other factors remain unchanged. The estimates do not take into account changes in taxpayer behaviour, consequential government actions or feedback on aggregate tax collections through induced changes in economic activity. Accordingly, the elimination of a tax expenditure would not necessarily yield the full tax revenues shown in Tables 1, 2 and 3.

Developing Historical Estimates

The majority of the personal income tax estimates in this report were computed with a personal income tax model. This model simulates changes to the personal income tax system using the statistical sample of tax returns collected by Revenue Canada for its annual publication *Taxation Statistics*. The model estimates the revenue impact of possible tax changes by recomputing taxes payable on the basis of adjusted values for all relevant income components, deductions and credits. For example, the removal of the moving expense deduction would result not only in a change in net income but also in all of the credits, such as the medical expense tax credit, whose values depend on net income. For those tax expenditures whose costs could not be estimated using this model alone, supplementary data were acquired from a variety of sources. Details on data sources and the methodologies used for estimating the cost of specific personal income tax measures are provided in Chapter 4.

A corporate income tax model was used to measure most of the corporate tax expenditures. As with the personal income tax model, it is based on a statistical sample of tax returns collected by Revenue Canada, and is able to recompute taxes payable on the basis of adjusted tax provisions. This recomputation of taxes takes into account the availability of unused tax credits, tax reductions, deductions and losses that would be used by the corporation to minimize its tax liability. Where costs could not be estimated using this model alone, supplementary data acquired from a variety of sources were used. Details on these sources are provided in Chapter 5.

Estimating the cost of tax deferrals presents a number of methodological difficulties since, even though the tax is not currently received, it may be collected at some point in the future. It is therefore necessary to derive estimates of the cost to the government of providing such a tax deferral while at the same time ensuring comparability with the other estimates presented here.

In this report, income tax deferrals are estimated on a “current cash-flow” basis – that is, the cost is computed as the forgone tax revenue associated with the additional net deferral in the year (deductions for the current year less the income inclusion from previous deferrals). The estimates thus computed provide a reasonably accurate picture of the ongoing costs of maintaining a particular tax provision in a mature tax system. They can be aggregated over time without double counting and are comparable to estimates of the costs associated with tax credits and deductions.

The costs of the majority of the GST tax expenditures presented in this report were estimated using a Sales Tax Model based on Statistics Canada's input-output tables and the National Income and Expenditure Accounts. In cases where estimates were not derived using this model, supplementary data from a variety of sources were used. Details on both the data sources and methodologies are provided in Chapter 6.

Developing Future Projections

As with the historical estimates, the projections represent the estimated amount by which federal tax revenues would be reduced due to the tax expenditure, assuming that all measures are evaluated independently. This means that the projections cannot be aggregated. In addition, it is assumed that all other factors remain unchanged. Thus, the projections make no provision for any behavioural change that might result from the removal of the provision; for any consequential policy changes that might accompany the change; or for the possible impact of the change on overall economic activity and thus on tax revenues. The projections do, however, take into consideration the impact of announced tax changes.

In contrast to the estimates of tax expenditures for the historical period, when values of the tax expenditures can generally be obtained from tax statistics or other historical data, projections of tax expenditures must rely on estimated relationships between tax expenditures and explanatory economic variables. Using these relationships, the values for the explanatory variables are projected into the future and so permit an estimation of the future expected values of tax expenditures. Key explanatory variables are generally those reflecting the state of the economy.

Projections for the explanatory variables are based either on the 1999 budget forecasts (e.g. gross domestic product, population, employment, corporate profits, inflation, consumer spending) or on past trends in the tax expenditure. Where projected tax expenditures were not obtained using these approaches, information on the alternative methodology is provided in Chapter 4 for personal income tax, Chapter 5 for corporate income tax and Chapter 6 for GST tax expenditures.

Any projections are inherently subject to forecast error, and quite substantial errors at times. Those familiar with forecasts prepared for the Canadian economy or for any other economy recognize that forecasting is not a science. Future values for key explanatory variables are based on best judgments, and unchanged policies are assumed for the forecast period. Furthermore, the relationships between variables that are being explained and those that provide the explanation may not be robust and could quickly change over time. For all these reasons, the projected values of tax expenditures should be treated as "best efforts," which do not have any greater degree of reliability than the variables that explain them. For example, if the level of gross domestic product (GDP) explains a tax expenditure, one would not expect the projected level of tax expenditure to materialize if the expected level of GDP did not occur. Even if the expected level of GDP did occur, the level of the tax expenditure might still not materialize if, in the future,

the relationship between the tax expenditure and GDP turns out to be different from that estimated on average in the past. Therefore, in general, one should expect that the degree of reliability of the projected tax expenditures should be less than that of the underlying explanatory variables.

Comparison With Direct Expenditures

In comparing the cost of the tax expenditures in this report to direct spending estimates, it should be noted that a dollar of tax preference is often worth substantially more to the taxpayer than a dollar of direct spending. This results from the fact that, in most cases, government grants (i.e. direct spending) are taxable to the recipients. For example, consider an individual facing a marginal tax rate of 29 per cent. A deduction of $100 would be worth $29. If, instead, the government were to provide the individual with a taxable grant of $29, after-tax income would increase by only $20.59 since the individual would face an income tax liability of $8.41 ($29 x 29 per cent).

The same conclusions do not always apply to tax expenditures provided to corporate taxpayers. Consider, for example, an investment tax credit to a corporation with respect to capital equipment acquired to carry out scientific research and experimental development in Canada. The cost to the government of providing a 20-per-cent tax credit would, in most circumstances, be the same as it would be if the government had provided a direct grant of 20 per cent. This is because investment tax credits are considered to be assistance and are therefore treated in the same manner as direct government grants or subsidies. The 20-per-cent tax credit, like a direct grant, is either included in income, and subject to corporate income tax, or it reduces the capital or other costs deductible by the taxpayer.

Chapter 4

Description of Personal Income Tax Provisions

The descriptions of the specific tax measures contained in this chapter are intended as a simplified reference and are not detailed descriptions of specific tax measures.

A number of measures which primarily affect corporations, but also unincorporated businesses, are treated in Chapter 5 on the corporate income tax measures.

Explanations of the methodologies used to produce estimates and projections are provided where they deviate from the standard approach of using the personal income tax simulation model described in Chapter 3.

Culture and Recreation

Deduction for clergy residence

A taxpayer who is a full-time member of the clergy or regular minister of a religious denomination may deduct housing costs from income for tax purposes. Where a member of the clergy is supplied living accommodation by his/her employer or receives housing allowances, an offsetting deduction may be claimed to the extent that this benefit is included in income. The estimate for this item is based on the number of clergy in Canada and Statistics Canada expenditure data on rent.

Flow-through of capital cost allowance on Canadian films

Prior to 1995, the capital cost allowance (CCA) rate generally available on films was 30 per cent, subject to the half-year rule. On Canadian content films, the half-year rule did not apply. The CCA could be flowed through to investors and deducted against all sources of income. An additional allowance of up to the remaining undepreciated capital cost of the film was deductible against an investor's income from certified Canadian films.

Losses arising from CCA claimed at the partnership level and flowed through as limited partnership losses are included in the "Deduction of limited partnership losses" tax expenditure. It is estimated that 15 per cent of limited partnership losses relate to CCA on Canadian films.

The 1995 budget replaced the special tax shelter rules that applied to Canadian content films by a 12-per-cent credit that can be claimed only by certain film and video production corporations. Transitional rules for the 1995 taxation year allowed full deductibility of undepreciated capital cost against film income and the flow-through of the CCA to the investor only if the 12-per-cent refundable tax credit was not claimed in respect of the production.

Deduction for certain contributions by individuals who have taken vows of perpetual poverty

Where a person has taken a vow of perpetual poverty as a member of a religious order, that person may deduct donations to the religious order up to his/her total employment and pension income (but not investment or other income) in lieu of the charitable donations credit.

Write-off of Canadian art purchased by unincorporated businesses

Canadian art acquired by businesses for display in an office may be depreciated on a 20-per-cent declining-balance basis even though it may depreciate at a much slower rate, and may even appreciate.

No data are available.

Assistance for artists

Artists may deduct the costs of creating a work of art in the year the costs are incurred rather than in the year the work of art is sold.

Artists may also elect to value a charitable gift from their inventories at any amount up to its fair market value. This value is included in the artist's income. The percentage of income limit for the charitable donations tax credit does not apply.

No data are available.

Deduction for artists and musicians

Employed musicians are able to claim the cost of maintenance, rental, insurance and capital cost allowance on musical instruments against employment income earned as a musician.

Employed artists are also entitled to deduct expenses related to their artistic endeavours up to the lesser of $1,000 or 20 per cent of their income derived from employment in the arts.

No data are available.

Non-taxation of capital gains on gifts of cultural property

Certain objects certified as being of cultural importance to Canada are exempt from capital gains tax if donated to a designated museum or art gallery.

Such donations amounted to $101 million in 1994 and $99 million in 1995. However, there is no information on the portion of the value which represents capital gains.

Education

Tuition fee credit

A 17-per-cent tax credit is available for tuition fees paid by students to a prescribed educational institution. A credit is available with respect to fees paid to an institution if the total tuition fees paid to the institution exceed $100. The 1997 budget extended the credit to most mandatory ancillary fees imposed by post-secondary institutions, starting in 1997.

Education credit

Students who are enrolled at prescribed educational institutions on a full-time basis are entitled to claim a tax credit of 17 per cent of an education amount. The amount was $80 for every month of full-time attendance for 1994 and 1995, and $100 for 1996. The 1997 budget increased the amount to $150 for 1997, and to $200 for 1998 and subsequent taxation years.

The 1998 budget proposed to extend this tax relief to part-time students for 1998 and subsequent years. Students enrolled at an educational institution in Canada in an eligible program lasting at least three consecutive weeks and involving a minimum of 12 hours of courses each month will be eligible. For each qualifying month, the education amount will be $60 per month, to which the 17-per-cent credit will be applied.

Education and tuition fee credits transferred

The unused portions of the education and the tuition fee amounts may be transferred to a supporting spouse, parent or grandparent. The maximum transfer for the two credits combined was 17 per cent of $4,000 for taxation years 1994 and 1995 and of $5,000 for 1996 and subsequent taxation years.

Carry-forward of education and tuition fee credits

Effective 1997, students may carry forward indefinitely, for their own use, education and tuition fee amounts that have not been either already used by the student or transferred to a supporting individual.

Student loan interest credit

In order to ease the burden of student debt, the 1998 budget proposed a 17-per-cent tax credit on the interest portion of student loan payments made in a year for 1998 and subsequent years. The credit may be claimed in the year in which it is earned or in any of the subsequent five years.

Registered education savings plans

A taxpayer may contribute to a registered education savings plan (RESP) on behalf of a designated beneficiary (usually the taxpayer's child). Contributions to RESPs are not deductible, but are usually returned to the subscriber free of tax. The investment return on these funds is not taxable until they are withdrawn for the education of the named beneficiary. In 1994 and 1995, the annual contribution in respect of a beneficiary could not exceed $1,500, with an overall limit

of $31,500. Effective 1996, the annual limit was increased to $2,000 with an overall limit of $42,000. In 1997, the annual limit was increased to $4,000.

Starting in 1998, RESP contributors are allowed, under certain conditions, to receive investment income from their plan either directly or through their registered retirement savings plans (RRSPs) where beneficiaries of the plan do not pursue higher education. The income received directly is subject to regular tax plus a deferral tax of 20 per cent while the amount transferred to an RRSP is subject to available RRSP room as well as lifetime limitations. Prior to 1998, RESP income could be used only for educational purposes, and was generally taxable in the hands of the beneficiary.

Effective in 1998, the government supplements contributions to RESPs with a 20-per-cent grant (the Canada Education Savings Grant -- CESG), subject to annual and lifetime limitations. While this enhancement does not directly represent a tax expenditure, the grant increases the cost of the tax expenditure to the extent that it encourages the use of RESPs.

Estimates are based on the data and projections provided by the CESG program. No data are available for years prior to 1996.

Exemption on first $500 of scholarship, fellowship and bursary income

The first $500 of scholarship, fellowship and bursary income is exempt from income tax.

The tax expenditures reported in the table are understated since no data are available on individuals receiving scholarship, fellowship or bursary income of less than $500.

Deduction of teachers' exchange fund contributions

Teachers may deduct up to $250 per year in contributions to a fund established by the Canadian Education Association for the benefit of teachers from Commonwealth countries visiting Canada under a teachers' exchange agreement.

Employment

Deduction of home relocation loans

For up to five years, an offsetting deduction from taxable income is provided for the benefit received by an employee in respect of a home relocation loan. The amount of the deduction is the lesser of the amount included in income as a taxable benefit and the amount of the benefit that would arise in respect of an interest-free loan of $25,000.

Non-taxation of allowances for volunteer firefighters

Volunteer firefighters were eligible to receive up to $500 per year in non-taxable allowances. The 1998 budget proposed to replace this measure with an exemption of up to $1,000 for amounts received by emergency service volunteers.

The estimates are based on census data.

Deduction for emergency service volunteers

The 1998 budget proposed to provide a tax exemption of up to $1,000 for amounts received by emergency service volunteers who, in their capacity as volunteers, are called upon to assist in emergencies or disasters.

Northern residents deductions

Individuals living in prescribed areas in Canada for a specified period may claim the northern residents deductions. The benefits consist of a residency deduction of up to $15 a day, a deduction for two employer-provided vacation trips per year, and unlimited employer-provided medical travel. Residents of the Northern Zone are eligible for full benefits, while residents of the Intermediate Zone are eligible for 50 per cent of the benefits.

The current definition of prescribed areas came into force in 1991. However, the implementation of the current system was gradual. Certain communities, which had qualified under the pre-1991 regime but which are no longer eligible under the current system, received full benefits until 1992, two-thirds benefits in 1993, one-third benefits in 1994, and zero benefits thereafter. Communities in the Intermediate Zone which had qualified under the pre-1991 regime received full benefits until 1992, two-thirds benefits in 1993, and 50-per-cent benefits thereafter.

Overseas employment credit

A tax credit is available to Canadian employees working abroad for more than six months in connection with certain resource, construction, installation, agricultural or engineering projects. The credit is equal to the tax otherwise payable on 80 per cent of the employee's net overseas employment income taxable in Canada (up to a maximum income of $80,000).

Employee stock options

Provided certain conditions are met, the benefits provided by employee stock options (ESOs) are taxed at a preferential rate. A deduction equal to one-quarter of the value of the benefit from the ESO is available to offset the tax liability on the option.

For employees of Canadian-controlled private corporations (CCPCs), the benefits accruing from ESOs are not generally included in income until the disposition of shares acquired with the options. However, the shares must be held for a minimum of two years to qualify for the one-quarter deduction. For non-CCPCs, the benefit provided by an ESO must be included in income when the option is exercised.

Estimates presented in the table reflect the one-quarter deduction, but not the benefit from the deferred inclusion in income of benefits accruing under ESOs.

Non-taxation of strike pay

Strike pay is non-taxable.

Statistics Canada has ceased collecting information on the amount of strike pay.

Deferral of salary through leave of absence/sabbatical plans

Employees may be entitled to defer salaries through a leave of absence/sabbatical plan. Provided certain conditions are met by the plan, these amounts are not subject to tax until received.

No data are available.

Employee benefit plans

In certain circumstances, employers may make contributions to an "employee benefit plan" on behalf of their employees. The employee is not required to include in income the contributions to the plan or the investment income earned within the plan until amounts are received. Employers may not deduct these contributions to the plan until these contributions are actually distributed to the employees.

No data are available.

Non-taxation of certain non-monetary employment benefits

Fringe benefits provided to employees by their employers are not taxed when it is not administratively feasible to determine the value of the benefit. Examples include merchandise discounts, subsidized recreational facilities offered to all employees and special clothing.

No data are available.

Family

Spousal credit

A taxpayer supporting a spouse is entitled to a tax credit of 17 per cent of $5,380. This credit is reduced by 17 per cent of the amount by which the dependent spouse's income exceeds $538. The 1999 budget proposes to increase the maximum amount of the credit to 17 per cent of $6,055 and to raise the threshold at which the credit amount begins to be reduced to $606, effective July 1, 1999.

Effective with the 1993 taxation year, the definition of spouse for tax purposes has been expanded to include common-law spouses, provided that the couple has lived together at least one year or has a common child.

Equivalent-to-spouse credit

An "equivalent-to-spouse" tax credit may be claimed in respect of a dependent child under age 18 or a parent or grandparent by taxpayers without a spouse. The amount of the credit and the

limitation on the dependant's income are the same as for the spousal credit. The 1999 budget proposal to increase the spousal credit will also apply to the equivalent-to-spouse credit.

Infirm dependant credit

For taxation years 1994 and 1995, taxpayers could claim the dependant credit for dependent relatives over 17 years of age who were physically or mentally infirm. The credit was 17 per cent of $1,583 for dependants whose income was below $2,690. The credit was reduced by 17 per cent of the dependant's net income in excess of that amount and was exhausted when the dependant's net income exceeded $4,273.

Effective in the 1996 taxation year, the amount on which the credit is based is $2,353 and the credit begins to be phased out at $4,103.

Caregiver credit

The 1998 budget proposed to provide a caregiver tax credit of up to $400 for individuals residing with, and providing in-home care for, an elderly parent or grandparent or an infirm dependent relative. The credit amount will be reduced by the dependant's net income in excess of $11,500. This measure is effective for 1998 and subsequent years.

Canada Child Tax Benefit

The Canada Child Tax Benefit (CCTB) was introduced in 1993 (until July 1998, it was called the Child Tax Benefit), replacing the family allowance, the dependant credit for children under 18 years of age and the refundable child tax credit. The CCTB payments are made monthly and are non-taxable.

The CCTB has two key components, i.e. the base benefit and the National Child Benefit (NCB) supplement. The base benefit provides a basic amount of up to $1,020 per child, plus $75 for the third and subsequent child. It also includes a supplement of $213 for each child under age 7, the total of which is reduced by 25 per cent of child care expenses claimed. The total base benefit is reduced by 5 per cent (2.5 per cent for one-child families) of family net income over $25,921.

The NCB supplement provides maximum benefits of $605 for the first child, $405 for the second child and $330 for each subsequent child. The NCB supplement is reduced by 11 per cent for a one-child family, 19.7 per cent for a two-child family and 27.6 per cent for larger families with incomes over $20,921. The NCB supplement is completely eliminated at $25,921.

The CCTB was changed in the 1997 and 1998 budgets as follows:

- In July 1997, the Working Income Supplement (WIS) was enriched and restructured. The maximum benefit under the WIS increased from $500 per family to $605 for the first child, $405 for the second child and $330 for each subsequent child.
- In July 1998, the NCB supplement replaced the WIS. The maximum NCB supplement was fixed at $605 for the first child, $405 for the second child and $330 for each subsequent child.

The 1999 budget, released February 16, proposed changes to both the NCB supplement and the base benefit.

- In July 1999, the NCB supplement will increase by $180 per child, to reach $785 for the first child, $585 for the second child and $510 for each subsequent child. The threshold at which the NCB supplement is fully phased out will be extended to $27,750 from $25,921.
- In July 2000, the NCB supplement will increase by an additional $170 per child, to reach $955 for the first child, $755 for the second child and $680 for each subsequent child. The threshold at which the NCB supplement is fully phased out will be extended to $29,590 from $27,750.

Also in July 2000, the income threshold at which the base benefit begins to be phased out will be increased to $29,590 from its current level of $25,921. This will provide increased benefits to 2 million families with income over $25,921.

Deferral of capital gains through transfers to a spouse, spousal trust or family trust

Individuals may transfer capital property to their spouses or spousal trusts at the adjusted cost base of the property rather than the fair market value. This provides a deferral of the capital gain until the subsequent disposition of the property or until the transferee spouse dies.

Property transferred to other family members or to unrelated individuals (or to trusts of which they are beneficiaries) is treated differently. The transferor is generally deemed to have disposed of the property at the time of transfer at fair market value and must include any resulting capital gain in income at that time.

In the case of property transferred to a trust (other than a spousal trust), capital gains are generally considered to be realized at the time of the transfer on the basis of the fair market value of the property at that time. In addition, trust assets are generally subject to a deemed realization every 21 years at the fair market value of the assets. The 21-year deemed realization date was deferred for certain electing trusts. However, the 1995 budget eliminated this election and prevents any deferral of the 21-year realization beyond January 1, 1999.

Farming and Fishing

$500,000 lifetime capital gains exemption for farm property

A $500,000 lifetime capital gains exemption is available for gains in respect of the disposition of qualified farm property. The $500,000 limit is reduced to the extent that the basic $100,000 lifetime capital gains exemption (where applicable) and the $500,000 lifetime capital gains exemption on small business shares have been used. Further, it can be applied only to the extent that the gains exceed cumulative net investment losses incurred after 1987.

Net Income Stabilization Account

Farmers may deposit a percentage of a given year's eligible net sales, up to a limit, to their Net Income Stabilization Account (NISA). No tax deduction is given in respect of these deposits. Some of the deposits are matchable by the federal and provincial governments. Governments also pay a 3-per-cent interest bonus annually on the farmer's deposits which remain in the account. Governments' contributions and interest accrued in the account are not taxable until withdrawn. All withdrawals from the NISA are taxable except for the contributor's original deposits, which were made with after-tax dollars. Withdrawal entitlements from the NISA are triggered if the current year gross margin (net sales less eligible expenses) is less than the average gross margin from previous years (up to five), or if net income is below $10,000 (or $20,000 of family net income if the family held only one account).

The federal tax expenditure is a function of two components: the deferral of tax on the investment income accrued in the account and on government contributions to the account; and the income inclusion of these amounts when withdrawn from the account. The former has the effect of increasing tax expenditures, while the latter has the opposite effect. The estimates provided in the table are made on a current cash-flow basis – that is, they measure the impact on revenues of the tax measure in each of the years under consideration.

Deferral of income from destruction of livestock

If the taxpayer elects, when there has been a statutory forced destruction of livestock, the income received from the forced destruction can be deemed to be income in the following year. The deferral is also available when the herd has been reduced by at least 15 per cent in a drought year. This provision allows for a deferral of income to the following year when the livestock is replaced. Under the benchmark tax system, income is taxable when it accrues.

The estimates are based on data provided by Agriculture Canada.

Deferral of income from grain sold through cash purchase tickets

Under the cash purchase ticket program of the Canadian Wheat Board, farmers may make deliveries of grain before the year-end and receive payment in the form of a ticket that may be cashed in subsequent years. The payment is included in income only when the ticket is cashed.

The estimates are based on data provided by the Canadian Wheat Board.

Deferral through 10-year capital gain reserve

If proceeds from a sale of a farm property to a child, grandchild or great-grandchild are not all receivable in the year of sale, realization of a portion of the capital gain may be deferred until the year in which the proceeds become receivable. However, a minimum of 10 per cent of the gain must be brought into income each year, creating a maximum 10-year reserve period. For most other assets, the maximum reserve period is five years.

Deferral of capital gain through intergenerational rollovers of family farms

Sales or gifts of assets to children, grandchildren or great-grandchildren typically give rise to taxable capital gains to the extent that the fair market value exceeds the adjusted cost base of the property. However, capital gains on intergenerational transfers of farm property are deferred in certain circumstances until the property is disposed of outside the immediate family.

No data are available.

Exemption from making quarterly tax instalments

Taxpayers earning business income must normally pay quarterly income tax instalments. However, individuals engaged in farming and fishing pay two-thirds of their estimated tax payable at the end of the taxation year and the remainder on or before April 30 of the following year.

No data are available.

Cash basis accounting

Individuals engaged in farming and fishing may elect to include revenues when received, rather than when earned, and deduct expenses when paid rather than when the related revenue is reported. This treatment allows a deferral of income inclusion and a current deduction for prepaid expenses. Under the benchmark tax structure, income is taxable when it accrues and expenses are deductible for the period to which they relate.

No data are available.

Flexibility in inventory accounting

Farmers using the cash basis method of accounting are allowed to depart from it with regard to their inventory. Under cash accounting, net additions to inventory are treated as a cost which is deducted in computing income. When inventory is increasing from year to year, such costs could create a loss for tax purposes. However, a discretionary amount not exceeding the fair market value of farm inventory on hand at year-end may be added back to income each year. This amount must then be deducted from income in the following year. The effect of this provision is to allow farmers to avoid creating losses which would be subject to the time limitation if carried forward. The value of the tax expenditure is thus the amount of tax relief associated with the losses that would otherwise have been subject to the time limitations.

No data are available.

Federal-Provincial Financing Arrangements

Quebec abatement

Under the contracting-out arrangements which were offered to provinces in the mid-1960s for certain federal transfer programs, provinces could elect to receive part of the federal contribution in the form of a tax abatement. Quebec was the only province to elect this arrangement at the time and this has resulted in a 16.5-percentage-point abatement of federal tax for Quebec residents.

Transfers of income tax room to provinces

In 1967, the federal government transferred tax points to all provinces in place of certain direct cash transfers under the cost-shared program for post-secondary education. As a result, the personal income tax abatement was increased by 4 percentage points. In 1977, an additional 9.5 percentage points of individual income tax were provided to the provinces in respect of post-secondary, hospital insurance and medicare programs.

General Business and Investment

$100,000 lifetime capital gains exemption

The 1994 budget eliminated the $100,000 lifetime capital gains exemption (LCGE) for gains accrued after February 22, 1994. Accrued gains prior to that date were grandfathered. Individuals who had not disposed of their assets on that date were allowed to elect to claim the $100,000 LCGE on their 1994 tax return for gains accrued up to February 22, 1994. They were deemed to have disposed of their assets for an amount not exceeding their fair market value on that date.

The LCGE allowed individuals to exempt up to $100,000 in realized capital gains over their lifetime. The exemption was available only to the extent that the gains exceeded cumulative net investment losses incurred after 1987. The costs of tax expenditures associated with capital gains realized on exempt qualified farm property and exempt qualified small business shares are listed separately, even though some of these gains would qualify for the $100,000 LCGE.

The 1992 budget had already eliminated the exemption for real estate gains accruing after February 1992 on property not used in an active business.

Partial inclusion of capital gains

Only three-quarters of net realized capital gains are included in income.

Deduction of limited partnership losses

A limited partner is able to deduct losses against other income up to the amount of investment at risk whereas a shareholder is normally not permitted to deduct corporate losses against personal income. Unused losses may be carried back three years or forward seven years.

Limited partnership losses arise from a range of investments, from real estate investments to certified film productions. It is estimated that 15 per cent of this tax expenditure for years before 1995 is attributable to capital cost allowance claimed on Canadian films.

Investment tax credits

Tax credits are available for investments in scientific research and experimental development, exploration activities and certain regions. The tax credits range from 15 per cent to 45 per cent. The estimates treat the full investment tax credit as a tax expenditure even though tax credits reduce the capital cost of assets for capital cost allowance purposes and the adjusted cost base for capital gains purposes. A more detailed explanation is provided in Chapter 5.

Deferral through five-year capital gain reserve

If proceeds from a sale of capital property are not all receivable in the year of the sale, realization of a portion of the capital gain may be deferred until the year in which the proceeds are received. A minimum of 20 per cent of the gain must be brought into income each year, creating a maximum five-year reserve period.

Deferral through capital gains rollovers

In certain circumstances, taxpayers may defer the reporting of capital gains for tax purposes. General business rollover provisions may be categorized into three groups:

Involuntary dispositions

Capital gains resulting from an involuntary disposition (e.g. insurance proceeds received for an asset destroyed in a fire) may be deferred if the funds are reinvested in a replacement asset within a specified period. The capital gain is taxable upon disposition of the replacement property.

Voluntary dispositions

Capital gains resulting from the voluntary disposition of land and buildings by businesses may be deferred if replacement properties are purchased soon thereafter (for example, a business changing location). The rollover is generally not available for properties used to generate rental income.

Transfers to a corporation for consideration including shares

Individuals may transfer an asset to a corporation controlled by them or their spouses and elect to roll over any resulting capital gain or recaptured depreciation into the corporation instead of paying tax in the year of sale.

No data are available.

Deferral through billed-basis accounting by professionals

Under accrual accounting, costs must be matched with their associated revenues. In computing their income for tax purposes, however, professionals are allowed to elect either an accrual or

a billed-basis accounting method. Under the latter method, the costs of work in progress can be written off as incurred even though the associated revenues are not brought into income until the bill is paid or becomes receivable. This treatment gives rise to a deferral of tax.

No data are available.

Deduction of accelerated tax depreciation

The depreciation allowable for tax purposes is called capital cost allowance. It may differ from true economic depreciation. A tax deferral may thus be created when the tax deductions in the early years of the life of an asset exceed the actual depreciation in the value of the asset. The difference is captured upon subsequent disposition of the asset.

The methodology for estimating this tax expenditure is explained in Chapter 5.

$1,000 capital gains exemption on personal-use property

Personal-use property is held primarily for the use and enjoyment of the owner rather than as an investment.

In calculating the capital gain on personal-use property, if the proceeds of disposition are less than $1,000, no capital gain needs to be reported. If the proceeds exceed this amount, the adjusted cost base (ACB) will be deemed to be a minimum of $1,000, thus reducing the capital gain in situations where the true ACB is less than $1,000.

No data are available.

$200 capital gains exemption on foreign exchange transactions

The first $200 of net capital gains on foreign exchange transactions is exempt from tax.

No data are available.

Taxation of capital gains upon realization

Capital gains are taxed upon the disposition of property and not when they accrue. This provides a tax deferral.

No data are available.

Health

Non-taxation of business-paid insurance benefits for group private health and dental plans

Employer-paid benefits for private health and dental plans are not taxable. The 1998 budget proposed to extend this measure to allow deductions from business income of self-employed persons for amounts paid for private health service plan coverage, subject to certain restrictions.

The estimates are based on data from Statistics Canada and from an annual survey, entitled *Health Insurance Benefits in Canada*, conducted by the Canadian Life and Health Insurance Association.

Disability credit

Canadians who are markedly restricted by disabilities in the carrying on of the basic activities of daily living are entitled to a tax credit. The credit is 17 per cent of $4,233. Any unused amount of the credit may be transferred to a supporting person.

Medical expense credit

Taxpayers are entitled to a 17-per-cent credit for eligible medical expenses incurred by the taxpayer, the taxpayer's spouse or by dependants. The credit is available in respect of expenses which exceed the lesser of 3 per cent of net income or $1,614. The 1998 budget proposed to allow supporting persons to claim the medical expense tax credit for training courses related to the care of dependent relatives with physical or mental infirmities. The 1999 budget proposes to extend the medical expense tax credit to include certain costs of group homes for disabled persons, certain therapies for disabled persons and tutoring and talking books for persons with learning disabilities.

Medical expense supplement for earners

The 1997 budget created a refundable medical expense credit for low-income working Canadians with high medical expenses.

The new refundable credit supplements the assistance that is provided through the existing medical expense tax credit. The maximum refundable credit is the lesser of $500 and 25 per cent of eligible medical expenses. It is available to those individuals earning over $2,500, and is reduced by 5 per cent of net family income in excess of $16,069.

Income Maintenance and Retirement

The non-taxation of income-tested programs such as the guaranteed income supplement and provincial social assistance presents conceptual difficulties. The problems arise because, in many respects, these programs operate like an income tax in that eligibility for benefits is phased out after a certain income level. In this regard, excluding such benefits from income tax might not be considered a tax expenditure since they are subject to their own "tax." On the other hand, a broadly based benchmark tax system would include such amounts in income. Given the comprehensive approach taken in this document, these items are considered to be tax expenditures.

Non-taxation of guaranteed income supplement and spouse's allowance benefits

The guaranteed income supplement (GIS) is an income-tested benefit payable to old age security (OAS) pensioners. Spouses of OAS recipients (or widows/widowers) between ages 60 and 64 may be eligible for the spouse's allowance (SPA). Benefits under both the GIS and SPA programs are non-taxable. Although GIS and SPA benefits must be included in income, an offsetting deduction from net income is provided. This approach effectively exempts such payments from taxation while continuing to have them affect income-tested credits.

The estimates are based on data from Human Resources Development Canada and the personal income tax simulation model developed by the Department of Finance from tax data.

Non-taxation of social assistance benefits

Social assistance benefits must be included in income. However, an offsetting deduction from net income is provided. This approach effectively exempts such benefits from taxation while continuing to have them affect income-tested credits.

The estimates are based on data from Human Resources Development Canada and the personal income tax simulation model developed by the Department of Finance from tax data.

Non-taxation of workers' compensation benefits

Workers' compensation benefits must be included in income. However, an offsetting deduction from net income is provided. This approach effectively exempts such benefits from taxation while continuing to have them affect income-tested credits.

Non-taxation of certain amounts received as damages in respect of personal injury or death

Amounts received in respect of damages for personal injury or death and awards paid pursuant to the authority of criminal injury compensation laws are not taxable. In addition, investment income earned on personal injury awards is excluded from income until the end of the year in which the person reaches the age of 21.

The values reported in the tables understate the tax expenditure since they are based on awards paid by provinces' Criminal Injuries Compensation Boards only. No data were available for compensation awards paid by other sources, or regarding the investment income earned on awards by individuals under age 22.

Non-taxation of employer-paid premiums for group term life insurance of up to $25,000

Employer-paid premiums for group term life insurance coverage of up to $25,000 per employee paid before July 1, 1994 were not taxable.

The 1994 budget eliminated the tax exemption, effective July 1, 1994.

Non-taxation of veterans' allowances, civilian war pensions and allowances, and other service pensions (including those from Allied countries)

These amounts are not included in income for tax purposes.

The estimates are based on public accounts data.

Non-taxation of veterans' disability pensions and support for dependants

These amounts are not included in income for tax purposes.

The estimates for this item are based on public accounts data.

Treatment of alimony and maintenance payments

Payments by a taxpayer to a divorced or separated spouse are deductible to the payer and taxable in the hands of the recipient for agreements or awards made prior to May 1, 1997.

This treatment represented a tax expenditure because it departed from the benchmark system established for the purposes of this report. Under this benchmark tax system, deductions are permitted only for expenses incurred in order to earn income, and amounts received from other individuals are not included in the income of the recipient.

As of May 1, 1997, child support paid pursuant to a written agreement or court order made on or after that day will not be deductible to the payer nor included in the income of the recipient. Child support paid pursuant to a court order or written agreement made before that date will continue to be deductible to the payer and included in the income of the recipient, unless the agreement is varied. The tax changes do not apply to spousal support. Spousal support payments remain deductible by the payer and are included in the income of the recipient.

The estimates for this item are computed as the value of the deduction to the payer less the tax collected from the recipient.

Age credit

Individual taxpayers age 65 or over are entitled to claim a tax credit of up to 17 per cent of $3,482. Unused portions may be transferred to a spouse. The age credit became subject to an income test in 1994. The age amount was reduced by 7.5 per cent of net income in excess of $25,921 in 1994, and by 15 per cent for 1995 and future years.

Pension income credit

A 17-per-cent tax credit is available on up to $1,000 of certain pension income. The unused portion of the credit may be transferred to a spouse.

Saskatchewan Pension Plan

Contributions to the Saskatchewan Pension Plan are deductible up to the lesser of $600 or the amount of unused registered retirement savings plan room in a particular year.

Registered pension plans/registered retirement savings plans

The federal revenue forgone due to the provisions pertaining to registered retirement savings plans (RRSPs), registered pension plans (RPPs) and deferred profit-sharing plans (DPSPs) is a function of three components: the deductibility of contributions to such plans; the non-taxation of investment income accrued within such plans; and the income inclusion of RPP/RRSP withdrawals, which reduces the cost resulting from the previous two. Individuals benefit from a deferral of tax on amounts contributed and on investment income. Also, there is an absolute tax saving to the extent that the tax rate on withdrawals is below that faced at the time of contributions. That is, many contributors are in a higher tax bracket during their working lives than when they are retired.

As noted in Chapter 3, the estimates provided in the table are made on a current cash-flow basis – that is, they measure the impact of the tax measure on revenues in each of the years under consideration. The Auditor General has recommended that the estimates for RPPs and RRSPs be provided on a present-value basis, as well the current cash-flow estimates. Work is proceeding on developing such estimates, although they are not yet ready to be included in this year's report.

In 1991, a new system of comprehensive limits on tax-assisted retirement saving took effect. Under this system, saving in RRSPs, RPPs and DPSPs is governed by a comprehensive limit of 18 per cent of earnings up to a dollar amount. In more detail, the limits are as follows.

- For defined benefit pension plans, the limits are the same as in 1990 – that is, there are no fixed limits on employee contributions while employer contributions are restricted to the amounts necessary to fully fund the promised benefits. Annual pension benefits under these pension plans are limited to the lesser of $1,722 and 2 per cent of earnings for each year of pensionable service.
- For RRSPs, contributions are limited to 18 per cent of earned income for the preceding taxation year up to a dollar maximum ($13,500 for 1994, $14,500 for 1995 and $13,500 from 1996 to 2003), minus a pension adjustment (PA). The PA is based on RPP or DPSP benefits earned by plan members in the previous taxation year. For a money purchase RPP or a DPSP, the PA is simply the total contribution made by, or on behalf of, a plan member in the year. For a defined benefit RPP, the PA is a measure of the benefits earned in the year, calculated according to a prescribed formula.

In 1992, the federal government introduced the Home Buyers' Plan as a temporary measure. It allowed all individuals to withdraw up to $20,000 from their RRSPs on a tax-free basis to purchase a home. Amounts withdrawn under the Home Buyers' Plan are to be repaid to the individual's RRSP on an interest-free basis over a period of 15 years. Amounts that are not repaid

are included in the individual's income for tax purposes. In 1994, this measure was made permanent, but restricted to first-time home buyers only. The 1998 budget proposed to allow persons eligible for the disability tax credit to participate in the Home Buyers' Plan more than once in the individual's lifetime. The funds must be used to purchase a home that is more accessible for, or better suited for, the care of the individual. The impact of the Home Buyers' Plan on the cost of RRSPs is expected to be small.

The 1998 budget also proposed to allow individuals to make tax-free RRSP withdrawals for lifelong learning, subject to certain restrictions. Individuals will have to repay these amounts over a fixed period of time. In many ways, this program parallels the Home Buyers' Plan.

It should be noted that the RRSP/RPP estimates do not reflect a mature system because contributions currently exceed withdrawals. Assuming a constant tax rate, if contributions equalled withdrawals, only the non-taxation of investment income would contribute to the net cost of the tax expenditure. As time goes by and more retired individuals have had the opportunity to contribute to RRSPs throughout their lifetime, the gap between contributions and withdrawals will shrink and possibly even become negative. The upward bias in the current cash-flow estimates can therefore be expected to decline.

The estimates may not reflect the benefit to a particular individual in any given year because the individual is typically either a contributor or withdrawer at a point in time, but not both. In order to estimate the benefit to a particular individual, one could calculate the difference in disposable income between a situation in which that individual invests in an RRSP/RPP and one in which that individual invests in a non-sheltered savings instrument.

Data used to estimate the value of these measures were taken from the personal income tax model, unpublished data from Statistics Canada, and from Statistics Canada publications *Trusteed Pension Funds* (Cat. 74-201) and *Pension Plans in Canada* (Cat. 74-401), as well as from the *Bank of Canada Review.*

Deferred profit-sharing plans

Employers may make tax-deductible contributions to a profit-sharing plan on behalf of their employees. These amounts are taxable in the hands of the employees when withdrawals are made from the plan. The employer's contribution cannot exceed one-half of the money purchase RPP dollar limit for the year ($7,250 in 1994 to 2003) or 18 per cent of the employee's earnings. The amount is included in the PA for the taxpayer. The taxpayer's total PA (for both RPP and DPSP contributions) cannot exceed the money purchase RPP dollar limit for the year ($14,500 for 1994 to 2003).

No data are available.

Non-taxation of RCMP pensions/compensation in respect of injury, disability or death

Pension payments and other compensation received in respect of an injury, disability or death associated with service in the Royal Canadian Mounted Police are non-taxable.

No data are available.

Non-taxation of up to $10,000 of death benefits

Up to $10,000 of death benefits paid by an employer to the spouse of a deceased employee is non-taxable.

No data are available.

Non-taxation of investment income on life insurance policies

The investment income earned on some life insurance policies is not taxed as income to the policyholder. Instead, for reasons of administrative convenience, insurance companies are subject to tax on such earnings.

(See Chapter 5 under "Interest credited to life insurance policies" for a further description of this measure and the corporate income tax expenditure tables for estimates of the cost of the tax expenditure involved.)

Small Business

$500,000 lifetime capital gains exemption for small business shares

A $500,000 lifetime capital gains exemption is available for gains in respect of the disposition of qualified small business shares. The $500,000 limit is available only to the extent that the basic $100,000 lifetime capital gains exemption (where applicable) and the $500,000 lifetime capital gains exemption on qualified farm property have not been used, and to the extent that the gains exceed cumulative net investment losses incurred after 1987.

Deduction of allowable business investment losses

Under the benchmark system, capital losses arising from the disposition of shares and debts are generally deductible only against capital gains. However, three-quarters of capital losses in respect of shares or debts of a small business corporation (allowable business investment losses) may be used to offset other income. Unused allowable business investment losses may be carried back three years and forward seven years. After seven years, the loss reverts to an ordinary capital loss and may be carried forward indefinitely.

The estimated tax expenditure is the amount of tax relief provided by allowing these losses to be deducted from other income in the year. The tax expenditure is overestimated since it does not reflect the future reduction in tax revenues that would occur if those losses were instead deducted from future capital gains.

Labour-sponsored venture capital corporations credit

A tax credit is provided to individuals for the acquisition of shares of labour-sponsored venture capital corporations. For shares acquired before March 6, 1996, the rate of the federal credit was 20 per cent to a maximum credit of $1,000. For shares acquired after March 5, 1996, the rate of the federal tax credit is 15 per cent, to a maximum credit of $525. In August 1998, the government proposed to raise the maximum credit to $750, effective for 1998 and subsequent years.

Deferral through 10-year capital gain reserve

If proceeds from the sale of small business shares to children, grandchildren or great-grandchildren are not all receivable in the year of sale, recognition of a portion of the capital gain realized may be deferred until the year in which the proceeds become receivable. However, a minimum of 10 per cent of the gain must be brought into income each year creating a maximum 10-year reserve period. This contrasts with the treatment of most other property where the maximum reserve period is five years.

Other Items

Non-taxation of capital gains on principal residences

Capital gains realized on the disposition of a taxpayer's principal residence are non-taxable. The capital gains were determined using Multiple Listing Service housing prices, adjusted to include expenditures on capital repairs and major additions and renovations, obtained from Statistics Canada's Consumer Expenditure Survey. The holding period for principal residences was derived from 1981 Census data.

Estimates for this item are provided for both partial and full inclusion rates for capital gains.

Non-taxation of income from the Office of the Governor General

This income is exempt from personal income taxation.

Data were provided by the Office of the Governor General.

Assistance for prospectors and grubstakers

Where a prospector or grubstaker disposes of mining property to a corporation in exchange for shares in that corporation, the tax liability is deferred until the subsequent disposition of the shares. At that time, only three-quarters of the amount for which the mining property was transferred to the corporation need be included in income.

Charitable donations credit

Donations of up to 50 per cent of net income for taxation year 1996 (20 per cent prior to 1996) made to registered charities qualified for the charitable donation credit in the year. The 1997 budget further increased the limit for 1997 and subsequent years to 75 per cent of net income. Provision was

made in 1996 and maintained in the 1997 measures to ensure that no short-term tax liability would arise from the realization of capital gains on donations of appreciated assets. This treatment was extended by the 1997 budget to any capital cost allowance recapture arising from the donation of depreciable capital property. Donations in excess of the limit may be carried forward for up to five years. The percentage of income restriction does not apply to certain gifts of cultural property nor, beginning in 1995, to donations of ecologically sensitive lands.

The credit is 17 per cent on the first $200 of total donations (including gifts to the Crown) and 29 per cent on donations in excess of $200.

Reduced inclusion rate for capital gains arising from certain charitable donations

The 1997 budget reduced the inclusion rate on capital gains arising from certain donations by individuals or corporations to charities (other than private charitable foundations) from 75 per cent to 37½ per cent where the donation is made between February 18, 1997 and the end of the year 2001. Eligible securities qualifying for this treatment are those for which a current value can readily be obtained and d publicly on a prescribed stock exchange.

Gifts to the Crown credit

A tax credit is available for gifts to the Crown. The credit is 17 per cent on the first $200 of total donations (including charitable donations) and 29 per cent on donations in excess of $200. Prior to 1997, tax credits arising from gifts to the Crown could be used to reduce taxes on up to 100 per cent of income.

The 1997 budgetreduced this to 75 per cent of income for 1997 and subsequent years. The limit is increased by 25 per cent of the amount of taxable capital gains arising from the donations of appreciated capital property and 25 per cent of any capital cost allowance recapture arising from the donation of depreciable capital property. Donations of ecologically sensitive land and certain gifts of cultural property are exempt from the net income limit. The limit does not apply to gifts in the year of death and the preceding year. Unused contributions may be carried forward for up to five years.

Political contribution credit

A credit is available for donations to registered federal political parties. The credit is 75 per cent of the first $100 of contributions, 50 per cent on the next $450 of contributions and 33⅓ per cent on the next $600. The maximum credit claimable in any year is $500.

Retroactive lump-sum payments

The 1999 budget proposes to allow taxpayers receiving qualifying retroactive lump-sum payments to use a special mechanism to compute the tax on those payments. To be eligible for the special tax calculation, the right to receive the income must have existed in a prior year. In addition, the principal portion of the lump-sum payment must be at least $3,000 and must have

been received in any year after 1994. The tax under the special mechanism is the federal tax that would have been payable if the principal portion of the retroactive lump-sum payment had been taxed in the year to which it relates, plus interest, to reflect the delay in receiving the tax.

The tax expenditure under this item is equal to the difference between the tax that would be owed on the principal portion of eligible retroactive lump-sum payments if they were taxed in the year received, and the tax computed under the special mechanism. There is no tax expenditure associated with the interest element of any lump-sum payment, because it is fully included in income for the year in which it is received.

Non-taxation of income of Indians on reserves

Section 87 of the *Indian Act* exempts the personal property of a status Indian and Indian bands from taxation if such personal property is situated on a reserve. Courts have held that the term "personal property" includes income. Determining whether income is situated on a reserve requires an examination of the factors that connect it to a reserve. With respect to employment income, for example, a key factor is the location (on or off a reserve) at which the employment duties were performed.

No data are available.

Non-taxation of gifts and bequests

Gifts and bequests are not included in the income of the recipient for tax purposes.

No data are available.

Memorandum Items

Non-taxation of lottery and gambling winnings

Lottery and gambling winnings are excluded from income for tax purposes.

The estimate for the non-taxation of winnings in government lotteries is based on information provided by Statistics Canada. Values for the non-taxation of winnings from horse racing are estimated using data provided by Agriculture Canada. The values do not include winnings from other types of gambling, such as bingo and casino winnings, where no accurate data are available.

The tax expenditure estimate assumes that the total amount of lottery and horse racing winnings would be included in income and subject to tax. This would likely not be the case because there would be a large administrative cost in taxing thousands of small prizes, in particular instant win lotteries. A threshold below which winnings would be non-taxable would result in substantially lower revenues than the figure published in this report.

It should also be noted that proceeds from the sale of lottery tickets are an important source of funds for provincial governments and not-for-profit organizations. As a result, there is already a considerable element of taxation to lottery and gambling proceeds.

This estimate is therefore included as a memorandum item only.

Non-taxation of specified incidental expenses

Members of Parliament (MPs), Members of Legislative Assemblies (MLAs), Senators and some other public officials (such as elected municipal officials and judges) receive flat allowances for expenses incidental to their duties. These amounts are not included in income for tax purposes.

This provision is a memorandum item because it is not possible to distinguish the proportion of these allowances which is used for personal consumption and that which is for work-related expenses.

Data are available only for the non-taxable allowances provided to MPs, MLAs and Senators. This information is found in the publications *Canadian Legislatures* and *The Canadian Parliamentary Guide*.

Non-taxation of allowances for diplomats and other government employees posted abroad

Diplomats and other government employees posted abroad receive an allowance to cover the additional costs associated with living outside Canada. These allowances are not taxable.

Information on total allowances was obtained from the Treasury Board.

Child care expense deduction

Child care expenses incurred for the purpose of earning business or employment income, taking an occupational training course or carrying on research for which a grant is received are deductible, up to a limit. Prior to 1998, the deduction could not exceed the lesser of $5,000 per child if the child was under age 7 or was disabled plus $3,000 per child between 7 and 14 years of age (16 years after 1995); two-thirds of earned income for the year; and the actual amount of child care expenses incurred. The two-thirds earned income limit does not apply to single parent students after 1995. The deduction must generally be claimed by the spouse with the lower income. However, the higher-income parent may claim a deduction if the lower-income parent is infirm, confined to a bed or a wheelchair, in prison, or attending a designated educational institution on a full-time basis.

The 1998 budget proposed to enhance the child care expense deduction by increasing the deduction limits by $2000 to $7000 for children under age 7 or disabled, and by $1000 to $4000 for older children. The budget also proposed to allow child care expenses incurred by an individual in order to pursue part-time education to be claimed, subject to certain limits.

Attendant care expense deduction

A disabled individual can deduct the cost of unreimbursed care provided by a part-time attendant, if such an expense is required to enable the individual to work. For taxation years 1994 to 1997, the deduction cannot exceed the lesser of $5,000 and two-thirds of earned income for the year. The 1997 budget eliminated the limit on attendant care expenses.

Moving expense deduction

All reasonable moving expenses incurred to earn employment or self-employment income at a new location (e.g. transportation, meals and temporary accommodation, cost of selling a former residence) are deductible from earnings or business income received after the move if the taxpayer moves at least 40 kilometres closer to the new place of employment or study. The deduction has to be claimed in the year, or in the following year if it exceeds earnings at the new location in the year of the move.

Prior to 1998, most moving expense reimbursements provided by employers were not included in income. The 1998 budget proposed to include certain employer-provided reimbursements in income, and to allow an offsetting deduction to the same extent as permitted for self-paid expenses. The 1998 budget also proposed to expand the definition of relocation costs eligible for deduction.

The estimates do not include non-taxable reimbursements received from employers.

Deduction of carrying charges incurred to earn income

Interest and other carrying charges, such as investment counselling fees and safety deposit box charges, incurred to earn business or investment income are deductible.

Some might consider the deductibility of such expenses to be a tax expenditure because of the tax deferral arising from the up-front deduction of expenses associated with the earning of income which will not be taxed until received possibly in future years. Others would hold that carrying charges are incurred for the purpose of earning income and therefore represent part of the benchmark income tax system.

Deduction of meals and entertainment expenses

Meals and entertainment expenses are considered to be a memorandum item because the amount that should be deductible under a benchmark tax system is debatable. While a portion of these expenditures is incurred in order to earn income, there is an element of personal consumption associated with these expenditures. Consequently, only a partial deduction for these expenses would be permitted under the benchmark tax system.

The deduction is limited to 50 per cent of the cost of food, beverages and entertainment (80 per cent before March 1, 1994). Where the cost of food, beverages or entertainment is part of a package price which includes amounts not subject to the 50-per-cent limitation – for instance, the fee for a conference – the taxpayer is required to determine the value or make a reasonable estimate of the amount subject to the 50-per-cent limitation.

Deduction of farm losses for part-time farmers

Individuals whose major source of income is not farming are allowed to deduct farm losses against other income up to an annual maximum of $8,750.

Part-time farm losses that are not deductible in the current year may be carried back 3 years and forward 10 years to deduct against farm or non-farm income. The estimates include the cost of these carry-overs.

Farm and fishing loss carry-overs

Farm and fishing losses may be carried back 3 years and forward 10 years. Most other business losses may be carried forward only 7 years.

The only data that are available are prior years' losses carried forward to the current year. In this regard, the estimates do not include current year losses carried forward or back to other taxation years, nor do they include future losses carried back to the taxation year in question. The estimates do not include losses carried over by part-time farmers.

Capital loss carry-overs

Net capital losses may be carried back three years and forward indefinitely to offset capital gains of other years.

The only data which are available are prior years' losses carried forward to the current year to reduce taxes payable. The estimates do not include current-year losses carried forward or back to other taxation years nor do they include future losses carried back to the taxation year in question.

Non-capital loss carry-overs

Non-capital losses may be carried back three years and forward seven years to offset other income.

The only data which are available are prior years' losses carried forward to the current year to reduce taxes payable. Thus, the cost estimates may understate the true amount of revenue forgone because they do not include current-year losses carried forward or back to other taxation years, nor do they include future losses carried back to the taxation year in question.

Logging tax credit

The logging tax credit reduces federal taxes payable by the lesser of two-thirds of any logging tax paid to a province and 6⅔ per cent of income from logging operations in that province.

The estimates are based on data from Revenue Canada.

Deduction of resource-related expenditures

Individuals are entitled to deduct certain expenses associated with the exploration for, and development of, Canadian natural resources. These expenses are deductible if the taxpayer either engages directly in these resource activities or provides financing to a resource company which, in turn, "flows through" the tax deductions to the taxpayer.

A tax expenditure arises when a flow-through share investor is able to use deductions for exploration and development more quickly than would otherwise have been possible by the resource company that actually undertook these expenditures. This may be because the taxpayer has otherwise-taxable income in a year and the corporate issuer of the flow-through share does not. It may also be the direct result of a special provision for junior oil and gas companies whereby expenses that would otherwise be deductible at 30 per cent can be deducted at 100 per cent when "flowed through" using flow-through shares.

However, the available data do not permit a separation of expenses that are flowed through to investors and those that are incurred directly by the taxpayers. Accordingly, only some portion of resource-related expenditures deducted represents a true tax expenditure. Consequently, the total cost of all these deductions has been calculated, but these amounts are treated as a memorandum item.

Deduction of other employment expenses

Employees generally cannot deduct work-related expenses. However, specific employment expenses (e.g. automobile expenses, cost of meals and lodging for certain transport employees, legal expenses paid to collect salary) are deductible in certain circumstances in the computation of income.

This provision is a memorandum item because it is not possible to distinguish the proportion of these expenses which is used for personal consumption and that which is incurred in order to earn income.

Deduction of union and professional dues

Union and professional dues are fully deductible from income.

The mandatory nature of these payments leads to their classification as expenses incurred to earn income.

Employment insurance contribution credit/ non-taxation of employer-paid premiums

A 17-per-cent tax credit is provided for employment insurance (EI) contributions. Employer-paid premiums are not included in the employee's income.

The mandatory nature of EI contributions leads to their classification as expenses incurred to earn income.

Canada and Quebec Pension Plan contribution credit/ non-taxation of employer-paid premiums

A 17-per-cent tax credit is provided for Canada Pension Plan/Quebec Pension Plan (CPP/QPP) contributions by both employees and the self-employed. Employer-paid premiums are not included in the employee's income.

Again, since CPP/QPP contributions are mandatory, they are classified as expenses incurred to earn income.

Foreign tax credit

In order to avoid double taxation, a tax credit is provided in recognition of income taxes paid in foreign countries.

Dividend gross-up and credit

Dividends received from taxable Canadian corporations are "grossed up" by a factor of one-quarter and included in income. A tax credit equal to 13.33 per cent of the grossed-up amount is then provided, in recognition of taxes paid at the corporate level. These provisions contribute to the integration of the corporate and personal income tax systems.

Supplementary low-income credit

The 1998 budget proposed a supplement of $500 to the basic personal, spousal and equivalent-to-spouse non-refundable tax credits for low-income taxfilers. The supplementary amount for a single individual will be reduced by 4 per cent of income in excess of $6,956. The total amount available to an individual with an eligible dependant will be reduced by 4 per cent of the filer's income minus the total of $6,956 and the dependant's adjusted income. The 1999 budget proposes to extend the benefit of this credit to all taxpayers through the basic personal and spousal/equivalent-to-spouse credits, effective July 1, 1999.

Basic personal credit

All taxpayers qualify for a basic personal credit equal to 17 per cent of $6,456. The 1999 budget proposes to increase the basic personal credit to 17 per cent of $7,131, effective July 1, 1999.

Non-taxation of capital dividends

Private corporations may distribute the exempt one-quarter of any realized capital gains accumulated in their "capital dividend account" to their shareholders in the form of a capital dividend. This dividend is non-taxable. This measure is reported as a memorandum item since it contributes to the integration of the taxation of corporate and personal income.

No data are available.

Chapter 5

Description of Corporate Income Tax Provisions

The descriptions of the specific tax measures contained in this chapter are intended as a simplified reference and are not detailed descriptions of specific tax measures.

Many of the estimates and projections are provided using the corporate income tax micro-simulation model, which has been developed jointly with Revenue Canada.

Tax Rate Reductions

The following items are measures that reduce the statutory tax rate faced by a corporation. They are considered to be tax expenditures because income is taxed at a rate other than the generally applicable tax rate.

Low tax rate for small businesses

Corporations that are Canadian-controlled private corporations (CCPCs) are eligible for a small business tax rate reduction, known as the small business deduction. This deduction lowers the basic federal tax rate on the first $200,000 of active business income of CCPCs by 16 percentage points – from 28 per cent to 12 per cent.

Effective July 1, 1994, CCPCs with more than $15 million of taxable capital employed in Canada are no longer eligible for this rate reduction. In addition, CCPCs with between $10 million and $15 million of taxable capital employed in Canada have reduced access to the small business deduction.

Low tax rate for manufacturing and processing

Canadian manufacturing and processing income not eligible for the small business deduction is subject to a reduced tax rate, known as the manufacturing and processing profits deduction. This deduction lowers the basic federal tax rate on eligible income earned after 1993 by 7 percentage points – from 28 per cent to 21 per cent.

For 1993, the deduction lowered the basic federal tax rate on eligible income by 6 percentage points – from 28 per cent to 22 per cent.

The 1999 budget proposed a phased-in extension of the manufacturing and processing profits deduction to corporations that produce electrical energy or steam for sale.

Low tax rate for credit unions

Although not a private corporation for most purposes, a credit union is eligible for the small business deduction (i.e. 16 per cent of its taxable income). A credit union with more than $200,000 of active business income may be eligible for a deduction of 16 per cent of its taxable income where the total income of the corporation since 1971 is less than the corporation's

"maximum cumulative reserve," which is equal to 5 per cent of amounts owing to members (including members' deposits and share capital). The purpose of this tax concession is to permit a credit union to accumulate capital on a tax-preferred basis up to a maximum of 5 per cent of deposits and capital.

Exemption from branch tax for transportation, communications, banking and iron ore mining corporations

The branch tax is imposed on that portion of the income of non-resident corporations derived from the carrying on of business in Canada through a branch. If a Canadian branch has ceased active business operations, non-residents are liable for tax on capital gains on dispositions of taxable Canadian property. The rate is 25 per cent, but is frequently reduced by bilateral tax treaties to 15 per cent, 10 per cent or 5 per cent.

A corporation is exempt from the branch tax if it is:

- a bank;
- a corporation whose principal business is:
  - the transportation of persons or goods,
  - communications, or
  - mining iron ore in Canada; or
- an exempt corporation such as a registered charity.

Legislation will be introduced in Parliament to make foreign bank branches subject to the branch tax effective in 1999.

No data are available.

Exemption from tax for international banking centres

A prescribed financial institution's branch or office carrying on certain business in the cities of Montreal or Vancouver may qualify as an international banking centre (IBC) and therefore be exempt from tax on its income. To qualify as an IBC under the *Income Tax Act*, the branch's income must be derived from accepting deposits and making loans to non-residents. This measure, introduced in 1987, is considered a tax expenditure because a financial institution can undertake business with non-residents through a Canadian permanent establishment without being subject to Canadian income taxes.

No data are available.

Tax Credits

Investment tax credits

The following measures are credits against federal income taxes otherwise payable. They are considered to be tax expenditures because they provide incentives to taxpayers which invest in certain activities, such as scientific research and experimental development (SR&ED), or in certain capital assets in designated regions of the country.

The amount of an investment tax credit (ITC) is calculated as a percentage of the cost of eligible expenditures. ITCs can reduce federal income tax revenues in one of two ways. They may be:

- used to offset federal income taxes otherwise payable; or
- fully or partially refunded in the year they are incurred in the case of smaller Canadian-controlled private corporations (CCPCs).

Prior to 1994, there was a limitation on the amount of ITCs that could be utilized in a taxation year. Specifically, in most cases, ITCs could only be used to offset up to 75 per cent of a taxpayer's federal income tax and surtax otherwise payable. For CCPCs, a special rule permitted the full offset of federal tax on their business income eligible for the small business deduction. The annual ITC limitation had been introduced to reduce the number of large corporations that were profitable but did not pay income tax. However, as announced in the 1993 budget, the introduction of the large corporations tax eliminated the need for the annual ITC limitation and investment tax credits became fully deductible for all taxpayers for taxation years beginning after 1993.

Certain ITCs earned in a year may be refunded to individuals and qualifying corporations that cannot use them to reduce federal income taxes otherwise payable. The rate of refundability for these ITCs is generally 40 per cent. However, a qualifying CCPC may receive a refund of 100 per cent on SR&ED ITCs earned at the 35-per-cent rate in respect of up to $2 million of eligible current expenditures.

Prior to 1994, a qualifying corporation for the purposes of the refund was generally a CCPC with taxable income not exceeding $200,000 in the preceding year. However, the 1993 budget modified this rule in the case of the SR&ED ITC so that, after 1993, refundability phases out as the prior-year taxable income of a CCPC (or associated corporate group) rises above $200,000 and is eliminated entirely at $400,000. This change was made to reduce the negative consequences of exceeding the $200,000 limit by even a small amount. The change eases the transition between the start-up phase and the period of expansion that small businesses typically experience and provides more certainty to their business planning. In order to focus ITC benefits on smaller CCPCs, the 1994 budget introduced a further change to phase out refundability after 1995 for CCPCs with taxable capital employed in Canada exceeding $10 million and to fully eliminate refundability for CCPCs with taxable capital employed in Canada exceeding $15 million.

All refunds reduce the amount of ITC for carry-over purposes. Unused ITCs may be carried forward 10 years or back 3 years.

ITCs utilized or refunded in a year reduce either the undepreciated capital cost of the asset for capital cost allowance purposes or, in the case of SR&ED, the SR&ED pool. Credits earned in respect of a property acquired after 1989 and not immediately available for use may not become claimable or refundable until the property is available for use or has been held by the taxpayer for 2 years.

Issues in calculating the value of ITCs

To maintain consistency with the other estimates in this document, the amounts reported in the table estimate the forgone revenue for the year in question from each ITC. In other words, the estimates show how much additional revenue would have been collected by the government in the year if the ITC had been eliminated in that particular year. To do this, the amount of ITCs used in the year are separated into two components: ITCs that were both earned and used in the year, and ITCs that were earned in prior years but were carried forward and used in the year. The former represents credits in respect of current year expenditures. The costs of any applicable refunds of ITCs earned are included in these estimates. The latter item – ITCs earned in past years but not used until the current year – is itemized separately as an aggregate for all ITCs.

Another perspective on the revenue cost of each ITC may be obtained by looking at the amount of ITCs earned in a specific year. This information is provided in the following table for 1994 and 1995. However, it should be recognized that ITCs earned in the year are not necessarily used in the year – they may be used in a subsequent or previous year, subject to the carry-over rules. As a result, had the ITCs been eliminated, government revenues for the year would not have been higher by the amounts shown in the following table since it may take a number of years for ITCs earned in a year to be used by the taxpayer to reduce federal taxes.

Investment tax credits earned in the year

	1994[1]	1995
	($ millions)	
SR&ED ITC	1,563	1,596
Atlantic ITC	151	259
Special ITC	119	56
Small business ITC	203	0

[1] These 1994 figures are based on final data and may differ from the figures in last year's edition of this document, which were based on preliminary data.

SR&ED investment tax credit

There were three rates of SR&ED ITC prior to 1995: a general rate of 20 per cent; an enhanced rate of 35 per cent for CCPCs with prior-year taxable income of less than $200,000; and a rate of 30 per cent for the Atlantic provinces and the Gaspé region. The latter rate was eliminated in the 1994 budget effective after 1994. The maximum amount of SR&ED expenditures that can earn ITCs at the 35-per-cent rate in a year is $2 million.

The SR&ED ITC is earned on eligible current and capital expenditures in respect of SR&ED in Canada performed by, or on behalf of, a taxpayer and related to a business of the taxpayer.

Atlantic investment tax credit

Prior to 1995, the Atlantic investment tax credit (AITC) was available at a rate of 15 per cent in respect of eligible expenditures in the Atlantic region – i.e. Newfoundland, New Brunswick, Nova Scotia, Prince Edward Island, the Gaspé region and their associated offshore areas. The 1994 budget reduced the AITC rate to 10 per cent for eligible expenditures incurred after 1994.

The AITC is earned on eligible expenditures on new buildings, machinery and equipment employed in the following qualifying activities: farming, fishing, logging, mining, oil and gas, and manufacturing and processing.

The AITC is refundable at a rate of 40 per cent for qualifying CCPCs and individuals.

Special investment tax credit

Prior to 1995, the special investment tax credit (SITC) was provided at a rate of 30 per cent for eligible expenditures on new buildings, machinery and equipment used in qualifying activities in qualifying regions of Canada. The SITC was eliminated in the 1994 budget, effective January 1, 1995. However, certain activities in the Atlantic region continue to be eligible for the AITC.

Qualifying activities were defined under the *Regional Development Incentives Act* and its regulations, and generally included manufacturing and processing facilities located in a qualifying region with the exception of certain primary processing of natural resources.

Qualifying regions included northeastern British Columbia, northwestern Alberta, northern Saskatchewan, most of Manitoba, northern Ontario, northern Quebec and the Gaspé region, and areas of Atlantic Canada.

Small business investment tax credit

The small business investment tax credit was available at a rate of 10 per cent for eligible expenditures on machinery and equipment acquired after December 2, 1992 and before 1994 by unincorporated businesses, partnerships and CCPCs, other than those subject to the large corporations tax. The credit was not refundable.

ITCs claimed in current year but earned in prior years

These are tax credits that were earned by corporations in previous years but not claimed until the current year. There is a revenue cost to the government when the credits are used by corporations to reduce federal taxes payable. While the aggregate amount of these credits is known with some confidence, there is not enough information available to identify separately the amounts for each credit.

Political contribution tax credit

A non-refundable tax credit is available for contributions to registered federal political parties or candidates. The credit is earned at a rate of 75 per cent on the first $100 contributed, 50 per cent on the next $450 contributed and 33⅓ per cent on the next $600 contributed. The maximum credit is $500 and is available when the taxpayer has contributed $1,150.

This measure constitutes a tax expenditure because political contributions are not incurred to earn income.

Canadian film or video production tax credit

The Canadian film or video production tax credit was introduced in the 1995 budget for certified Canadian film productions produced by qualified corporations. It provides a refundable investment tax credit of 25 per cent of the cost of eligible salaries and wages expended after 1994, except where the financing of the film is eligible for transitional relief from the termination of the capital cost allowance (CCA) film incentive. Eligible salaries and wages are limited to 48 per cent of the cost of production, so that the credit provides assistance of up to 12 per cent of the cost of the production. Canadian film or video productions are certified by the Minister of Canadian Heritage.

This tax credit was intended to retarget government assistance available to Canadian film productions in order to maximize the benefit to such productions. It replaced a tax shelter of accelerated CCA deductions used principally by higher-income individuals, with a refundable tax credit for eligible films produced by qualified taxable Canadian corporations.

Film or video production services tax credit

The production services tax credit applies to film or video production services that are provided in Canada for films that do not have sufficient Canadian content to qualify for the Canadian film or video production tax credit. It is a refundable credit of 11 per cent of salaries and wages paid to Canadian residents for services performed in Canada after October 31, 1997. The Canadian Audio-Visual Certification Office of Canadian Heritage provides certificates of eligibility.

The tax credit is designed to provide economic development assistance to film and video productions produced in Canada and to enhance Canada as a location of choice for film and video productions. It was designed to retarget government assistance by making the benefit available directly to the production services provider. Previously, this assistance was provided through syndicated tax shelters for such productions.

Exemptions and Deductions

The following exemptions and deductions are considered tax expenditures because they deviate from the benchmark tax system.

Partial inclusion of capital gains

Three-quarters of net realized capital gains are included in income. The amount of the tax expenditure is the additional tax that would have been collected had the remaining one-quarter of the capital gains been included in income. However, this amount is likely an overestimate of the true amount of this tax expenditure. To the extent that the capital gains are from shares that have increased in value due to retained earnings, and which have already been taxed at the corporate level, the partial inclusion of the capital gains provides some relief from double taxation and, therefore, should be part of the benchmark tax system.

The 1997 budget reduced the inclusion rate on capital gains arising from certain donations to charities (other than private charitable foundations) from 75 per cent to 37½ per cent. Donations eligible are those of securities that are listed publicly on a recognized stock exchange in Canada, where the donation is made between February 18, 1997 and the end of the year 2001.

Royalties and mining taxes

Non-deductibility of Crown royalties and mining taxes

The current tax system does not permit a deduction for Crown royalties or mining taxes. The deduction has been denied since May 6, 1974. From that time to the end of 1975, oil and gas and mining companies were eligible for a resource tax abatement, which provided a lower rate of tax on oil and gas and mining income. A resource allowance (discussed below) was introduced in the June 1975 budget and replaced the resource tax abatement after 1975.

A negative tax expenditure is calculated for the non-deductibility of Crown royalties and mining taxes. A negative tax expenditure implies that the government collects more income taxes than would have otherwise occurred in the benchmark system. The issue arises as to whether the benchmark tax system would include a deduction for all Crown royalties and mining taxes. Two generic types of non-deductible Crown charges are levied on the extraction of natural resources. One type is a simple royalty system where the Crown charge is based only on gross revenues. There are also more complex systems of Crown charges that are based on net resource profits – i.e. resource profits after the deduction of numerous costs, including capital, operating costs and sometimes a return on capital employed.

In the case of Crown charges based on gross revenues, the benchmark system would include a deduction for these royalties since they are analogous to costs of production. However, the benchmark tax system would not include a deduction for the latter type of profit-related Crown royalties and mining taxes because they are structured more like income taxes. Provincial income taxes are not considered to be a deductible expense in the benchmark system. Provincial payroll and capital taxes, on the other hand, are deductible and they are not treated as tax expenditures.

The calculations shown in this report represent the federal corporate income tax revenues generated by the current rules which deny the deductibility of all Crown royalties and mining taxes. No attempt has been made to divide the disallowed royalties into the two categories described above. This is in part due to the fact that many royalty systems include characteristics of both a gross and net calculation. Thus, the calculation represents an overestimate of the actual negative tax expenditure.

Resource allowance

Since 1976, the income tax system has provided a resource allowance deduction equal to 25 per cent of a taxpayer's annual resource profits, computed after operating costs and capital cost allowances, but before the deduction of exploration expenses, development expenses, earned depletion and interest expenses. These latter expenses were excluded from the resource profit calculation primarily to encourage companies to undertake exploration and development activities in Canada. The resource allowance is provided in lieu of the deductibility of Crown royalties, mining taxes and other charges related to oil and gas or mining production. The measure allows the provinces room to impose royalties or mining taxes on the production of natural resources while maintaining the federal income tax base. For analytical purposes, the value of the tax expenditure for the royalties and mining taxes is broken down into two components:

- the federal tax revenue earned by disallowing royalty deductibility (a negative tax expenditure, described above); and
- the federal tax revenue forgone resulting from the resource allowance deduction (a positive tax expenditure).

An approximation of the overall impact of the resource allowance measure (compared to the benchmark tax system) can be obtained by netting the two above effects.

Earned depletion

Earned depletion is an additional deduction from taxable income of certain exploration and development expenditures and other resource investments. Prior to 1990, taxpayers were entitled to earn an extra deduction of up to 33⅓ per cent of most exploration and development expenses or the costs of assets related to new mines or major expansions. The deductions for earned depletion are generally limited to 25 per cent of the taxpayer's annual resource profits, although mining exploration depletion can be deducted against non-resource income. As in the case of a Canadian

exploration expense or a Canadian development expense, earned depletion could be pooled (i.e. placed in a special account, and any remaining balance could be carried forward indefinitely for use in later years).

Additions to the depletion pools for earned depletion and mining exploration depletion were eliminated as of January 1, 1990. Deductions can still be made on the basis of existing depletion pools.

Under the benchmark tax system, a deduction for earned depletion would not be available.

Deductibility of charitable donations

Donations made by corporations to registered charities are deductible in computing taxable income within certain limits. Unused deductions may be carried forward for up to five years.

For years prior to 1996, this deduction was limited to 20 per cent of net income. The 1996 budget announced that the deduction limit would be raised to 50 per cent of net income plus 50 per cent of taxable capital gains resulting from the donation of property. The 1997 budget announced a further increase in the limit to 75 per cent of net income plus 25 per cent of the amount of taxable capital gains arising from the donation of appreciated capital property and 25 per cent of any capital cost allowance recapture arising from the donation of depreciable capital property.

This deduction would not be permitted under the benchmark tax system because these expenditures are not incurred to earn income.

Deductibility of gifts to the Crown

Gifts made by corporations to Canada or a province are deductible in computing taxable income within certain limits. Unused deductions may be carried forward for up to five years.

Prior to 1997 the amount deductible was limited only to the amount of income in a particular year. The 1997 budget restricted the deductible amount to 75 per cent of net income plus 25 per cent of the amount of taxable capital gains arising from the donation of appreciated capital property and 25 per cent of any capital cost allowance recapture arising from the donation of depreciable capital property. The limit would not apply to gifts of ecologically sensitive land and certain gifts of cultural property.

This deduction would not be permitted under the benchmark tax system because these expenditures are not incurred to earn income.

Interest on small business financing loans

Small businesses in financial difficulty are able to treat interest paid on small business financing (SBF) loans entered into between February 25, 1992 and the end of 1994 as a non-deductible payment, and SBF lenders are permitted to treat the interest received as a dividend – resulting in

such interest being non-taxable to corporate lenders and individual lenders being eligible for a dividend tax credit. This tax treatment permitted lenders to reduce the interest charges to such small businesses while maintaining their after-tax rates of return.

Non-deductibility of advertising expenses in foreign media

Expenses for advertising in non-Canadian newspapers or periodicals or on non-Canadian broadcast media cannot generally be deducted for income tax purposes if they are directed primarily to a market in Canada. Deducting the cost of advertising in foreign periodicals or on television stations is not restricted if the advertising is to promote sales in foreign markets.

This treatment results in a negative tax expenditure since the deduction of an expense incurred to earn income is denied. Under the benchmark tax system, advertising expenses in foreign media incurred to gain or produce income from a business or property would be deductible whether targeted at foreign or domestic markets.

No data are available.

Non-taxation of provincial assistance for venture investments in small business

Government assistance received by a corporation is normally either included in the corporation's income or reduces the cost basis of the assets to which the assistance relates for capital cost allowance purposes. There are a number of exceptions to this rule, including provincial assistance provided for venture capital investment under specified provincial programs. Under the benchmark tax system, this type of assistance would be included in the corporation's income or would reduce the cost basis of the related assets.

No data are available.

Deferrals

The tax expenditures in this section provide for a deferral of income taxes from the current to a later taxation year. They have been valued on a cash-flow basis (i.e. the forgone tax revenue associated with the additional net deferral in the year). The alternative way of valuing deferrals would be to calculate the value of the interest-free loan that is provided to the taxpayer when taxes are deferred to a later year.

Accelerated write-off of capital assets and resource-related expenditures

Under the benchmark tax system, corporations would be permitted an annual deduction for their use of capital assets based on their anticipated economic life. Using the cash-flow approach, the tax expenditure in any particular year would be calculated as the forgone tax revenue resulting from the difference between the deduction taken for tax purposes, usually capital cost allowance (CCA), and the true economic depreciation based upon the asset's useful economic life.

These annual calculations of the impact on cash flow can provide some indication of the tax expenditures resulting from the accelerated deductions for capital assets, but they could also be very misleading.

Tax expenditure amounts are not provided because:

- differences between the deductions for tax purposes and economic depreciation may not accurately reflect the tax expenditure; and
- adequate data are not available to calculate with any degree of accuracy this tax expenditure.

There are instances when differences between the deductions for tax purposes and economic depreciation would not accurately reflect the tax expenditure. First, it should be noted that the accelerated deductions for tax purposes lead only to a deferral, not a permanent reduction, of tax payable. If CCA rates are higher than actual depreciation rates, then during the initial years, the CCA claim would exceed economic depreciation. However, in later taxation years, the reverse would occur (i.e. actual depreciation would exceed the amount allowed for tax purposes). These differences between CCA and actual depreciation would lead to a positive tax expenditure in the early years of asset ownership since higher CCA rates in the initial years are a tax incentive. However, in later years, the CCA claim would be less than actual depreciation, resulting in a negative tax expenditure, thus offsetting the previous tax expenditure to some extent. For the corporate sector in total, the aggregate tax expenditure in any particular year could be positive or negative depending upon the level of investment in the current and previous years. As a result, the tax expenditure depends critically on the growth rate of investments. If the growth rate were zero, then, in the long run, one would expect no tax expenditure amount since the positive tax expenditures resulting from more recent asset acquisitions would be offset by the negative tax expenditures resulting from older assets – that is, in total, the annual tax depreciation claimed would be equal to the economic depreciation.

In addition, because CCA is a discretionary deduction, the cash-flow method could result in a tax expenditure being reported even if there is no acceleration of CCA rates (i.e. the CCA rates correspond with economic depreciation rates). A company has discretion to claim less than the maximum amount in a particular year. As a result, in that year, the cash-flow method would result in a negative tax expenditure. Because the company would now have a larger undepreciated balance for tax purposes, future CCA write-offs would be larger than the corresponding economic depreciation, thereby resulting in a positive tax expenditure in future years.

Finally, differences between CCA and economic depreciation may also result from the treatment of dispositions. For tax purposes, assets are grouped in pools with gains or losses on disposition adjusting the undepreciated balance, while gains and losses for economic depreciation purposes are recognized on an asset-by-asset basis. Also, the asset cost for tax purposes may differ from the cost for economic depreciation purposes in that, for economic depreciation purposes, interest costs are often capitalized while, for tax purposes, such costs are generally expensed in the year incurred.

Because economic depreciation is difficult to determine, the deductions for capital assets reported by companies in their financial statements are often used as a substitute. However, financial statement depreciation may differ from economic depreciation. Furthermore, not all companies classify the capital asset deductions as depreciation or some other readily identifiable expense. For example, in the leasing industry, a lease may be classified as an operating lease for tax purposes with capital cost allowance being claimed, while for accounting purposes, it may be classified as a capital lease, in which case the corresponding accounting deduction may not be specifically identifiable. Since the costs written off for financial statement purposes for this sector cannot be precisely determined, it is not possible to estimate the related tax expenditure. More generally, adequate data are not available to calculate with any degree of accuracy this tax expenditure.

Although it may not be possible to estimate with any degree of accuracy the expenditure using the cash-flow approach, some indication of the magnitude of the tax expenditure relating to a particular accelerated write-off provision can be calculated by comparing the estimated discounted present value of the tax benefits resulting from acquisitions in a particular year under each of the two depreciation methods. For example, if the CCA rate is higher than the actual depreciation rate, the discounted present value of the benefit of being able to claim CCA would exceed the discounted present value of the benefit of the financial statement depreciation, thereby resulting in a measure of the positive tax expenditure or tax incentive that has been provided.

The number of asset classes with accelerated depreciation rates was reduced significantly when changes were introduced in 1988. As a result, many CCA rates now approximate the rate of economic or financial statement depreciation, and the associated tax expenditure related to accelerated depreciation provisions has been reduced. However, a few instances remain where the CCA rates are clearly accelerated – that is, the tax system allows a larger deduction from income for the first few years after the property is acquired than is applied for financial statement purposes. Some of the more significant of these accelerated CCA provisions are described below along with illustrations of the net present value of the benefit of some of the remaining accelerated CCA provisions.

Vessels (class 7)

Vessels are generally included in class 7 and are subject to a maximum CCA rate of 15 per cent on a declining-balance basis. Accelerated CCA on a straight-line basis at a maximum rate of 33⅓ per cent of the capital cost of the property is available in respect of a vessel, including furniture, fittings, radio communication equipment and other equipment if it was (a) constructed in Canada, (b) registered in Canada, and (c) not used for any purpose whatever before acquisition by the owner. These assets are depreciated over a four-year period, with 16⅔ per cent written off in the first and fourth years, and 33⅓ per cent written off in the second and third years.

Energy-efficient equipment (classes 34 and 43.1)

Prior to the changes announced in the 1994 budget, straight-line depreciation of 25 per cent, 50 per cent and 25 per cent was applicable to certain equipment used for the generation of electricity or the production or distribution of heat. Qualifying equipment includes equipment designed to: produce heat derived primarily from the consumption of wood wastes or municipal wastes; produce electrical energy by using wind energy; or recover heat that is a by-product of an industrial process. Also included as qualifying equipment were: hydroelectric installations not exceeding 15 megawatts; certain types of co-generation equipment; and certain types of active solar heating equipment.

The changes announced in the 1994 budget effectively terminated additions to class 34 after February 21, 1994, and redefined eligibility criteria. Many of the assets that had been eligible for class 34 became eligible for a reduced depreciation rate of 30 per cent on a declining-balance basis under class 43.1.

Class 43.1 was introduced following the termination of class 34. Eligibility for class 43.1 is described in regulations to the *Income Tax Act*. In general, the following types of equipment may qualify for inclusion in class 43.1: co-generation and specified waste-fuelled electrical generation systems; active solar systems; small-scale hydroelectric installations; heat recovery systems; wind energy conversion systems; photovoltaic electrical generation systems above a minimum threshold level; geothermal electrical generation systems; and specified waste-fuelled heat production equipment. Active solar systems, heat recovery systems and waste-fuelled heat production equipment must be used directly in connection with an industrial process to qualify as class 43.1 equipment. The 1999 budget proposed to include in class 43.1 equipment for the generation of electricity from gas that would otherwise be flared during the production of crude oil.

Class 43.1 is also subject to the "specified energy property" rules, which may reduce the amounts that can be deducted to less than 30 per cent of the unclaimed capital cost.

Water and air pollution control property (classes 24 and 27)

Assets which are acquired primarily for the purposes of abating water or air pollution at a site are included in class 24 or class 27, respectively. These assets are eligible for three-year straight-line CCA of 25 per cent, 50 per cent and 25 per cent. The water and air pollution control equipment must be new property that is used in operations that were started before 1974 and have been continuously carried on since that time. The 1994 budget announced that additions to these classes would be terminated after 1998.

Mining

Certain mining buildings, machinery and equipment acquired for use at a new mine or a major expansion of an existing mine may qualify for an accelerated CCA rate of up to 100 per cent. A 25-per-cent increase in a mine's capacity is generally considered to be a major expansion.

These mining assets were previously included in class 28 and depreciated at a rate of 30 per cent. Acquisitions after 1987 are included in class 41 and depreciated at a rate of 25 per cent. In addition to the 25-per-cent allowance provided in class 41, a taxpayer owning such property and operating the mine may claim an additional allowance equal to the lesser of (1) the remaining undepreciated capital cost of property of the class, or (2) the income for the year from the new or expanded mine.

The 1996 budget announced income tax changes for oil sands projects. The objective of the changes was to provide a more equitable tax treatment for the two different oil sands extraction methods (mining and *in situ*). Mining methods involve the removal of overburden and the transportation of bituminous sands to a central processing facility where the oil (bitumen) is separated from the sand using hot water. With *in situ* operations, the oil is recovered from an underground reservoir by the application of heat or other techniques, which make the oil more mobile and capable of flowing from a well or wells.

The 1996 budget extended the accelerated CCA rules to the eligible depreciable capital costs for *in situ* projects. The tax treatment that previously had been available only for new mines (both mineral and oil sands) and major mine expansions was also extended to other capital investments, including large incremental capital costs that might not otherwise qualify as a major expansion (e.g. efficiency improvements and environmental protection). Specifically, all tangible capital expenditures incurred for all types of mines, including oil sands projects, would qualify for accelerated CCA to the extent that, in a year, these capital costs exceeded 5 per cent of gross revenue from that mine or oil sands project in that year.

Exploration costs

Expenditures incurred in determining the existence, location, extent or quality of mineral resources, and oil or gas, or incurred to develop mineral resources prior to commercial production in Canada, are classified as a Canadian exploration expense (CEE) and are deducted for tax purposes at a rate of 100 per cent.

Generally accepted accounting principles allow companies to depreciate exploration expenditures on either a "full cost" or a "successful efforts" basis. The full cost method requires that all exploration costs, whether they result in new production or not, be capitalized and amortized as the reserves are depleted. The successful efforts method requires that only those costs which result in the discovery of reserves and which have a benefit in terms of future revenues are

capitalized; other costs are expensed as incurred. Most Canadian-controlled companies follow the full cost method, while foreign-controlled companies in Canada usually follow the successful efforts method.

The 100-per-cent write-off of CEE for tax purposes is more rapid than the amounts used for financial statement purposes, especially for successful exploration. The fast write-off for CEE provides a deferral of tax.

Under the benchmark tax system, corporations would be permitted an immediate deduction only for unsuccessful exploration expenditures. However, those costs associated with successful exploratory activities (i.e. those costs that result in producing assets for both the mining and oil and gas sectors) would be permitted a deduction based on an amortization over the life of the asset.

Under certain conditions, corporations entering into flow-through share agreements are entitled to reclassify limited amounts of a Canadian development expense (normally a 30-per-cent deduction on a declining-balance basis) into a Canadian exploration expense. The tax expenditure associated with this provision appears as a personal tax expenditure item on pages 75-76 since these deductions are taken by the purchasers of the flow-through shares, which are generally individuals.

Canadian Renewable and Conservation Expenses (CRCE)

This category of expenses was introduced to provide for full deductibility of certain costs associated with the development of renewable energy projects and other projects for which the equipment is eligible for accelerated deduction under class 43.1. Test wind turbines are also eligible to be claimed as a CRCE expense.

CRCE can be flowed out pursuant to a flow-through share agreement. It was introduced to provide a more equitable tax treatment for the financing of renewable and non-renewable energy projects.

Capital equipment used for scientific research and experimental development

Eligible capital expenditures for the provision of premises, facilities or equipment used for scientific research and experimental development in Canada may be fully deducted in the year they are incurred. In the absence of this provision, these amounts would have been depreciable over several years. Under the benchmark tax system, expenditures that are capital in nature and designed to produce income in the future are depreciated over a period approximating that during which the income is expected to arise.

Illustration

Assuming a taxable corporation makes a $100,000 investment in an eligible asset, the net present value of the income tax reduction resulting from accelerated CCA is presented in the following table. This illustration is based upon a federal corporate income tax rate of 29.12 per cent (unless otherwise indicated) and uses a discount rate of 8 per cent. The actual net present value of the reduced federal tax resulting from accelerated CCA will vary depending upon the tax status of the corporation, its effective tax rate and the amount of CCA actually claimed in future years. The following table presents the maximum value of the incentive assuming that firms can fully benefit from the accelerated CCA. The one exception is for the analysis of mining assets (see table footnote).

	CCA Class	Accelerated rate	Baseline tax depreciation rate	Net present value of reduced federal tax resulting from accelerated CCA
Vessels	7	33⅓% straight-line	15% declining balance	$5,800
Electrical generating equipment using wind, solar and geothermal energy	43.1	30% declining balance	4% declining balance	$9,700[1]
Energy-efficient equipment used in manufacturing and processing (pre-1994 budget)	34	50% straight-line	30% declining balance	$2,900[2]
Water and air pollution control property used in manufacturing and processing (pre-1999)	24 and 27	50% straight-line	30% declining balance	$2,900[2]
Mining assets				
Oil sands and *in situ* oil	28 and 41	100% (subject to income restriction)	25% declining balance	$500 to $4,000[3]
Conventional mines	28 and 41	100% (subject to income restriction)	25% declining balance	$500 to $1,300[4]
Scientific research and experimental development equipment	Full write-off in year	Full write-off in year	30% declining balance	$4,800
Exploration costs	Full write-off in year	Full write-off in year	30% declining balance	$4,800
Canadian Renewable and Conservation Expenses	Full write-off in year	Full write-off in year	30% declining balance	$3,700[1]

1 These amounts reflect the fully phased-in value of the 1999 budget proposal to provide, by 2002, the manufacturing and processing deduction for the production of electrical energy for sale.

2 This amount is calculated without reference to the manufacturing and processing deduction.

3 Accelerated CCA can only be claimed against income earned by the related project, not against total corporate income. The income of the project, in turn, depends *inter alia* on prices for oil/minerals. Therefore, the net present value of the federal tax reduction resulting from claiming accelerated CCA varies depending upon the amount of project income against which CCA may be claimed. These estimates are based on the operating results of a range of existing and proposed oil sands mining and *in situ* oil sands projects as obtained from industry sources. The calculations result in a range of $500 to $4,000 per $100,000 investment; however, most oil sands projects would generally fall between $700 and $2,500.

4 For conventional mines, the analysis was based on hypothetical mine models developed by Natural Resources Canada. These models include a range of low and high profitability metal mines.

Allowable business investment losses

Capital losses arising from the disposition of shares and debts are generally deductible only against capital gains. However, under the allowable business investment loss rules, three-quarters of capital losses in respect of shares or debts of a small business corporation may be used to offset other income.

Unused allowable business investment losses may be carried back three years and forward seven years. After seven years, the loss reverts to a capital loss and may be carried forward indefinitely.

The value of the tax expenditure is the amount of tax relief provided by allowing these losses to be deducted from other income in the year rather than being deducted against uncertain taxable capital gains in the future.

Holdback on progress payments to contractors

In the construction industry, contractors are typically given progress payments as construction proceeds. However, a portion of these progress payments (e.g. 10 per cent to 15 per cent) is often held back until the entire project is completed satisfactorily. The amount held back need not be brought into the income of the contractor until the project to which it applies is certified as complete, rather than when earned, as would be required in the benchmark tax structure. Where a contractor, in turn, withholds an amount from a subcontractor, costs equal to the amount of the holdback are not considered to have been incurred by the contractor and are not deductible until paid. The net impact of these two measures on a given contractor's tax liability depends on the ratio of holdbacks payable to holdbacks receivable. If holdbacks receivable are greater than holdbacks payable, there is a deferral of tax. If holdbacks payable exceed holdbacks receivable, there is a prepayment of taxes.

Increases in net holdbacks receivable or decreases in net holdbacks payable result in a positive estimate of the amount of the tax expenditure. Increases in net holdbacks payable or decreases in net holdbacks receivable result in a negative estimate.

Available for use

Taxpayers may claim capital cost allowance (CCA) and investment tax credits (ITCs) on eligible property at the earlier of the time it is put in use or in the second taxation year following the year of acquisition. Property that becomes eligible for CCA and ITCs by virtue of the two-year deferral rule could result in a significant mismatch of revenues and expenses which give rise to a tax deferral. This is a tax expenditure because taxpayers are allowed to claim deductions and tax credits on property before it is put in use.

No data are available as assets are pooled into classes and are not accounted for separately. Furthermore, assets are not identified as being "available for use" or "not available for use."

Capital gains taxation on realization basis

Capital gains are taxed upon the disposition of property and not on an accrual basis. This treatment results in a tax deferral. Furthermore, certain rollover mechanisms such as share-for-share exchange provisions extend the period of tax deferral. Under the benchmark tax system, capital gains would be fully included in income as they accrue.

However, since 1994, financial institutions and investment dealers have been required to report gains and losses on certain securities on an accrual basis (i.e. mark to market).

No data are available.

Expensing of advertising costs

Advertising expenses are deductible on a current basis even though some of these expenditures provide a benefit in the future. Under the benchmark tax system, the expenses would be amortized over the benefit period.

The estimates provided are based upon the assumption that 25 per cent of advertising costs incurred in a particular year provide a benefit in the following two years. Since tax expenditures are estimated on a cash-flow basis, an increase in annual advertising costs would result in a positive estimate of the tax expenditure. Decreases in annual advertising costs would result in a negative estimate of the tax expenditure.

Deductibility of contributions to mine reclamation and environmental trusts

Certain environmentally sensitive activities can disturb the natural environment in the area where the activity takes place, and measures may need to be taken to repair the environmental damage after operations have terminated. In these situations, governments may require companies to set aside funds in advance in trust funds to ensure that adequate amounts are available to conduct restoration activities at the end of operations.

The 1994 budget permitted a deduction of required contributions to mine reclamation trusts in the year in which they are made rather than permitting a deduction only when the mine reclamation costs are actually incurred. Income earned in such trusts is subject to tax each year. When actual reclamation costs are incurred, any withdrawal of funds from the trust will be included in income subject to tax and the actual reclamation costs will be deductible. The 1997 budget extended this treatment to similar funds established for waste disposal sites and quarries for the extraction of aggregate and other similar substances.

The overall effect is to advance the timing of the deduction in respect of reclamation expenses. The value of the tax expenditure is the amount of tax relief that is effectively provided by allowing payments to be deducted from income when contributions are made to the trust. This tax expenditure could be positive or negative depending upon the amount of contributions to and withdrawals from these trusts in a particular year.

Deductibility of countervailing and anti-dumping duties

In accordance with the rules established under the World Trade Organization, countervailing and anti-dumping duties may be imposed by countries to offset the injurious effects of imports which are subsidized or dumped. These actions may result in Canadian taxpayers paying such amounts in order to export their products. The 1998 budget proposed that cash outlays for duties be deductible in computing income subject to tax in the year they are paid even though these amounts may be refunded, in whole or in part, in a subsequent year. Any refunds or additional amounts subsequently received, such as interest, would have to be included in income in the year of receipt.

The value of the tax expenditure is the amount of tax relief provided by allowing these contingent costs to be deducted from income when paid rather than when the exact amount, if any, of the duty is determined. This tax expenditure could be positive or negative depending upon the amount of countervailing duties paid and recovered by firms in a particular year.

No forecasts have been made of the future tax expenditure amounts since it is not possible to determine the cost of future trade actions affecting Canadian taxpayers.

Deductibility of earthquake reserves

In 1997, the Office of the Superintendent of Financial Institutions introduced new guidelines that require federally regulated insurance companies to meet target levels of preparedness to ensure they have sufficient financial capacity to pay insured earthquake losses when they occur. The appendix to the guidelines proposes an earthquake reserve to be composed of two parts: the first element, the "earthquake premium reserve," is based on a percentage of net earthquake premiums written; the second element, the "earthquake reserve complement," takes into account the earthquake exposure reinsured with another insurance company and a proportion of the capital and surplus of the company. The 1998 budget proposed that the "earthquake premium reserve" would be deductible for income tax purposes. Under the benchmark system, such reserves would not be deductible.

Cash basis accounting

Farming and fishing corporations may elect to include revenues as received, rather than when earned, and deduct expenses when paid rather than when the related revenue is reported. This treatment allows a deferral of income and a current deduction for prepaid expenses. Under the benchmark tax structure, income is taxable when it accrues.

No data are available.

Flexibility in inventory accounting

Farm corporations using the cash basis method of accounting are allowed to depart from it with regard to their inventory. A discretionary amount, not exceeding the fair market value of farm inventory on hand at year-end, may be added back to income each year. This amount must then

be deducted from income in the following year. The effect of this provision is to allow farm corporations to avoid creating losses which, if carried forward, would be subject to the time limitation. Thus, the tax expenditure provides tax relief to the extent that the losses would otherwise have been subject to the time limitations.

No data are available.

Deferral of income from grain sold through cash purchase tickets

Farmers may make deliveries of grain before the year-end and be paid with a ticket that may be cashed only in the following year. The payment for deliveries of grain is included in income only when the ticket is cashed, thereby providing a deferral of taxes. Under the benchmark tax system, income would be taxed on an accrual basis.

The estimates are based on data provided by the Canadian Wheat Board. Since tax expenditures are estimated on a cash-flow basis, an increase in the balance of uncashed grain tickets represents additional income that is being deferred and results in a positive estimate of the tax expenditure. A decrease in the balance of uncashed grain tickets indicates that less income is being deferred and results in a negative tax expenditure.

Deferral of income from destruction of livestock

If the taxpayer elects, when there has been a statutory forced destruction of livestock, the income received from the forced destruction can be deemed to be income in the following year. The deferral is also available when the herd has been reduced by at least 15 per cent in a drought year. This provision allows for a deferral of income to the following year when the livestock is replaced. Under the benchmark tax system, income is taxed on an accrual basis.

Deferral of tax from use of billed-basis accounting by professionals

Under accrual accounting, costs must be matched with their associated revenues. However, in computing their income for tax purposes, professionals are allowed to elect either an accrual or a billed-basis accounting method. Under the latter method, the costs of work in progress can be written off as incurred even though the associated revenues are not brought into income until the bill is paid or becomes receivable. This treatment gives rise to a deferral of tax.

No data are available.

International

Non-taxation of life insurance companies' world income

All Canadian corporations except Canadian multinational life insurers are taxed on their worldwide income. Canadian multinational life insurers are taxed only on their profits from carrying on a life insurance business in Canada using special rules in the income tax regulations.

Prior to 1993, the cost of this tax expenditure was estimated from tax returns and information available from the Office of the Superintendent of Financial Institutions. However, information required to estimate this tax expenditure is not available after 1992.

Exemptions from non-resident withholding tax

Canada, like other countries, imposes a withholding tax on various types of income paid to non-residents. The basis for this tax rests on the internationally accepted principle that a country has the right to tax income that arises or has its source in that country. The types of income subject to non-resident withholding tax include: certain interest, dividends, rents, royalties and similar payments; management fees; estate and trust income, alimony and support payments; and certain pension, annuity and other payments.

Over time, as the benefits of freer trade in capital, goods and services have been increasingly recognized, countries including Canada have adjusted their tariff and tax structures to remove impediments to international transactions. Part of this adjustment has been the reduction of non-resident withholding tax on certain payments.

Canada's statutory non-resident withholding tax rate is 25 per cent. However, the rate is lowered and exemptions are provided for certain payments through an extensive network of bilateral tax treaties. These rate reductions, which apply on a reciprocal basis, differ depending on the type of income and the tax treaty country.

The *Income Tax Act* also provides for a number of unilateral exemptions from withholding tax, including exemptions for the following: interest payments on government debt; interest payments to arm's-length persons on long-term corporate debt; interest payments to arm's-length persons on foreign currency deposits with branches of Schedule I banks; and royalty payments for the use of copyright.

Lower withholding taxes can reduce the cost to Canadian business of accessing capital and other business inputs from abroad. For example, a lower Canadian withholding tax on interest payments to non-residents can reduce the cost of accessing foreign capital in cases where foreign creditors raise the interest rate charged to cover payment for withholding tax. Similarly, a reduced withholding tax on royalty payments can reduce the cost of accessing foreign technology and other property and services, and thereby enhance the competitiveness of Canadian businesses requiring these inputs.

The estimates of the tax expenditures associated with withholding tax exemptions for certain royalties, interest, dividends and management fees paid to non-residents were derived from a detailed analysis of payments to non-residents and withholding tax collections on those payments for 1992, 1993 and 1994, and projections of payments to non-residents over the post-1994 period. The cost estimates were derived by applying treaty withholding tax rates (in the case of payments to a country with which Canada had a tax treaty in the year considered) or the statutory 25-per-cent withholding tax rate (in the case of payments to non-treaty countries) that would otherwise

apply, in the absence of an exemption, to observed and projected payments data under the benchmark assumption used throughout this publication of no behavioural response to the hypothetical removal of existing withholding tax exemptions.

This benchmark assumption of no behavioural response is particularly difficult to sustain for this type of tax. Foreign providers of capital, technology and other property and services, in most cases, are unwilling to bear the withholding tax given that they do not pay such a tax when supplying other markets. If a withholding tax was to be imposed, foreign providers would either require that the tax be shifted back to the Canadian borrower or user of property or services in the form of higher charges (which in many cases could not be absorbed), or they would bypass Canada in favour of other foreign markets where such a tax does not exist, again implying increased financing and other business costs to Canadians. Indeed, these same competitiveness considerations have led to the introduction of a number of withholding tax exemptions both in Canada and in other countries.

Thus, these particular tax expenditure estimates cannot be interpreted as additional revenues that could be collected from non-residents if the withholding tax exemptions were removed, since the removal of the exemptions would generally involve the elimination of the tax base.

Exemption from Canadian income tax of income earned by non-residents from the operation of a ship or aircraft in international traffic

Non-resident persons operating a ship in international traffic are exempted from Canadian income tax as is done in other countries. Similarly, non-resident persons operating an airline in international traffic are exempted from Canadian income tax. In both cases, the exemption applies only if the non-resident's home country gives Canadian residents substantially similar tax relief. The amount of the tax expenditure is the tax that would otherwise be payable on profits related to the Canadian business of the non-resident persons, net of the tax collected on the non-Canadian income of the resident persons.

No data are available.

Other Tax Expenditures

Transfer of income tax room to provinces in respect of shared programs

In 1967, federal-provincial fiscal arrangements were altered. The federal government substituted a transfer of corporate income tax points for direct transfers to provinces under the cost-shared program for post-secondary education. The tax change involved an increase in the corporate income tax abatement rate from 9 to 10 percentage points, effectively reducing the federal corporate income tax rate at that time from 37 per cent to 36 per cent (the rate before the abatement was 46 per cent). This transfer of tax room has been included as a tax expenditure because it is a substitute for direct spending programs.

Interest credited to life insurance policies

Life insurance companies are taxed under the investment income tax (IIT) at a rate of 15 per cent on net investment earnings attributable to life insurance policies.

The IIT interacts with the taxation of policyholders. The *Income Tax Act* divides life insurance policies into two categories: savings-oriented policies and protection-oriented policies.

Savings-oriented policies are those where the amount of money invested in the policy is large relative to the death benefit. A holder of a savings-oriented policy is subject to annual accrual taxation in respect of the net investment earnings credited to the policy. Net investment earnings reported by these holders are subtracted from the IIT base in order to avoid double taxation of net investment earnings.

In contrast, a holder of a protection-oriented policy is not subject to annual accrual taxation. Net investment earnings are taxed when the policy is sold or surrendered, terminated (other than by death), or when paid out as policy dividends once the cumulative dividends exceed the total premiums paid under the policy. Net investment earnings that are taxable to holders of protection-oriented policies are also deductible from the IIT base.

Most of the cost of the tax expenditure relates to protection-oriented policies. This cost has three basic elements:

- differences between personal and IIT rates;
- timing differences (i.e. policies that are eventually taxed in the hands of policyholders); and
- permanent differences (i.e. policies that are held until the death of the insured).

Non-taxation of registered charities and other non-profit organizations

Registered charities and other non-profit organizations, both incorporated and unincorporated, are exempt from income tax. This is a tax preference to the extent that the charity or organization has taxable income, mainly investment income or profits from certain commercial activities.

No data are available.

Income tax exemption for provincial and municipal corporations

Provincial Crown corporations and municipal corporations are exempt from income tax. Under the benchmark tax structure, such corporations would be taxable to the extent that they had taxable income.

No data are available.

Non-taxation of certain federal Crown corporations

While federal Crown corporations are generally not subject to income tax, those Crown corporations that carry on significant commercial activities are taxable. It is possible, however, that some exempt corporations have income that would be taxable under the benchmark tax system.

No data are available.

Excise tax transportation rebate

The excise tax transportation rebate, introduced in 1991 and effective for the 1991 and 1992 calendar years, allowed transportation businesses to receive an excise tax rebate of 3 cents for each litre of eligible fuel on which federal fuel excise tax of 4 cents per litre was paid. In exchange, businesses that elected to receive this rebate were required to reduce their income tax losses by 10 dollars for every 1 dollar rebated. This provided the industry with an immediate cash-flow benefit at the cost of lower loss carry-forwards to offset income taxes in future years.

This rebate was applicable to purchases of diesel and aviation fuel subject to federal excise tax during the 1991 and 1992 calendar years.

A simpler option was available for trucking businesses that could elect to receive a rebate of 1½ cents per litre up to a maximum of $500 per taxpayer in lieu of the 3-cent-per-litre rebate.

Aviation fuel excise tax rebate

The aviation fuel excise tax rebate, which is effective for the calendar years 1997 to 2000 inclusive, provides excise tax rebates on the aviation fuel used by airline companies. Rebates are limited to $20 million per year per associated group of companies. In order to receive a rebate, a company must agree to reduce its income tax losses by 10 dollars for every 1 dollar of rebate.

Surtax on the profits of tobacco manufacturers

Tobacco manufacturers are subject to a special surtax on their profits. The surtax is levied at a rate of 40 per cent of the Part I tax on tobacco manufacturing profits. The surtax was originally announced as part of the National Action Plan to Combat Smuggling in February 1994. In November 1996, the government announced that the surtax would be extended for an additional three years to February 2000.

The surtax is considered a tax expenditure because it constitutes a departure from the benchmark system. Because the surtax results in more revenues than would otherwise be raised under the benchmark tax system, it is a negative tax expenditure.

Temporary tax on the capital of large deposit-taking institutions

The temporary surcharge is levied at a rate of 12 per cent of the financial institution capital tax imposed under Part VI of the *Income Tax Act* calculated before any credit for income taxes and as if there was a capital deduction of $400 million. The surcharge applies to financial institutions as defined under Part VI, but not to life insurance companies. The surcharge is not eligible to be offset by tax payable under Part I.

The surcharge was introduced in the 1995 budget for a period of 18 months and extended for one year in the 1996, 1997, and 1998 budgets. The 1999 budget proposes to extend the surcharge for another year to October 31, 2000.

The surcharge is considered a tax expenditure because it constitutes a departure from the benchmark system. Because the surcharge results in more revenues than would otherwise be raised under the benchmark tax system, it represents a negative tax expenditure.

Memorandum Items

Refundable Part I tax on investment income of private corporations

This and the following item are parts of the tax system that provide some integration between the personal and corporate tax systems. The estimates provided reflect the portion of corporate taxes collected that are refundable. If corporations and individuals were treated as separate tax units, these amounts would not be refundable.

A portion of the income taxes paid on investment income received by a private corporation (excluding deductible intercorporate dividends) is refunded to a Canadian-controlled private corporation (CCPC) when this income is paid out to shareholders as dividends.

Prior to July 1, 1995, a corporation's refundable tax equalled approximately 20 percentage points of the Part I tax paid on its investment income. To further ensure the integration of corporate and individual income taxes, an additional refundable tax of 6⅔ per cent is levied on the investment income received after June 30, 1995 by a CCPC. This additional tax is refunded to a private corporation, along with refundable Part I tax, when the investment income is paid to shareholders as dividends. Corporations receive a refund from their refundable tax account at a rate of one dollar for every three dollars of taxable dividends paid.

Refundable capital gains for investment corporations and mutual fund corporations

Capital gains realized by an investment corporation and a mutual fund corporation are taxed at the corporation level, and the tax is accumulated in the "refundable capital gains tax on hand" account. The corporation uses this account to claim a capital gains refund when it distributes

capital gains dividends to its shareholders or through share redemptions by a mutual fund corporation. Since these dividends are capital gains distributions, they are taxed as capital gains in the hands of the shareholder and not as dividends.

This measure is considered a tax expenditure because it constitutes a departure from the benchmark system by allowing a public corporation (that qualifies as an investment corporation or a mutual fund corporation) to flow out its capital gains to shareholders. The result is that the distributed capital gains will be taxed at the same rate as if the corporation were a private corporation.

Loss carry-overs

The cyclical nature of business and investment income suggests that the impact of such income should be viewed over a longer period of time rather than on an annual basis. As a result, carry-overs of losses are treated as part of the benchmark tax system. The loss carry-over rules permit taxpayers to apply their losses against past or future income. The estimates provided indicate approximately how much tax revenue the government forgoes by allowing current-year losses to be carried back (i.e. applied to reduce tax paid in previous years) and by allowing losses of previous years to be carried forward and applied to reduce tax otherwise payable for the current year. There are four types of losses that can be carried over, and specific provisions apply to each.

Non-capital losses

A non-capital loss is a company's loss from business operations. Non-capital losses may be carried back three years and forward seven years to reduce or offset the corporation's taxable income.

Estimates reflecting the impact of the carry-forward of prior years' losses include the revenue impact of allowing non-capital losses of previous years to be applied to reduce Part I tax and the refundable Part IV tax otherwise payable for the current year. Estimates reflecting the impact of allowing current-year losses to be carried back (i.e. applied to reduce income tax paid in previous years) include the impact of allowing current-year losses to be carried back to reduce both Part I tax and refundable Part IV tax.

Net capital losses

A net capital loss can arise from the disposition of capital property. This type of loss may be carried back three years and forward indefinitely but can only be applied against net taxable capital gains.

Estimates include the revenue impact of allowing net capital losses of previous years to be applied to reduce income tax otherwise payable for the current year and the impact of allowing current-year net capital losses to be carried back (i.e. applied to reduce income tax paid in previous years).

Farm losses and restricted farm losses

A corporation can deduct, in the calculation of net income, a loss incurred from a farming or fishing business. The unused losses of this business may be carried back 3 years and forward 10 years.

When the corporation's major source of income is not farming, the amount of farming losses deductible in the year is restricted to a maximum of $8,750. The unused losses, defined as the excess of the net farm losses over the farm losses deductible in the year, are considered restricted farm losses. Restricted farm losses may also be carried back 3 years and forward 10 years but can only be applied against farm income.

Estimates consist primarily of the revenue impact of allowing farming losses of previous years to be applied to reduce income tax otherwise payable for the current year.

The revenue impact of applying restricted farm losses is minimal.

Deductible meals and entertainment expenses

Meals and entertainment expenses are considered to be a memorandum item because the amount that should be deductible under a benchmark tax system is debatable. While a portion of these expenditures is incurred in order to earn income, there is an element of personal consumption associated with these expenditures. Consequently, only a partial deduction for these expenses would be permitted under the benchmark tax system.

The deduction is limited to 50 per cent of the cost of food, beverages and entertainment (80 per cent before March 1, 1994) in order to reflect the personal consumption portion of these costs. To the extent that the business-related portion (i.e. the amount deductible under the benchmark system) exceeds the 50-per-cent deductible portion (80 per cent before March 1, 1994) there would be a negative tax expenditure since too large a portion of the costs is denied. Conversely, if the business-related portion were less than the tax deductible portion, there would be a positive tax expenditure. The estimates provided reflect the additional tax revenue that would be received if no deduction were allowed (i.e. that there is no business purpose to the expenditure).

Large corporations tax

The large corporations tax (LCT) was introduced on July 1, 1989 as a tax on the Canadian capital of large corporations. The rate of tax in 1993 and 1994 was 0.2 per cent. The 1995 budget increased the LCT rate to 0.225 per cent effective budget day 1995.

This tax ensures that all large corporations, and groups of related corporations, with more than $10 million of taxable capital employed in Canada pay some federal tax. Companies can reduce their LCT liability to the extent of the Canadian portion of their corporate surtax. The rate of corporate surtax was increased from 3 per cent to 4 per cent in the 1995 budget.

Threshold

The $10-million capital deduction effectively exempts smaller corporations from the LCT as long as these corporations are not related to other corporations subject to the LCT – that is, the $10-million deduction must be shared among related corporations. This capital deduction is not considered to be a tax expenditure because it is generally available to all corporations.

Exempt corporations

Certain corporations such as non-resident investment corporations, deposit insurance corporations and corporations exempt from paying Part I income tax are exempt from paying the LCT. This exemption is a tax expenditure, but data are not available to estimate its value.

Patronage dividend deduction

In computing income for a taxation year, a taxpayer is allowed to deduct patronage dividend payments made to customers. Patronage dividends are payments made to customers in proportion to their volume of business. The taxpayer is required to withhold 15 per cent of all patronage dividends in excess of $100 paid to each customer who is resident in Canada.

The appropriate benchmark tax treatment of patronage dividends is uncertain. These dividends could be considered to be analogous to the payment of a volume discount or the return of excess payments. With this view of the benchmark system, this would not be a tax expenditure.

Alternatively, these payments could be perceived as the distribution to members (or shareholders) of earnings which would not be deductible under the benchmark system. The amount shown, reflecting this view of the benchmark system, is the revenue impact of allowing patronage dividends to be deductible from income.

Logging tax credit

The logging tax credit reduces federal taxes payable by the lesser of two-thirds of any logging tax paid to a province and 6⅔ per cent of income from logging operations in that province. This reduction in federal taxes can be argued to be a tax expenditure for the same reasons explained under the analysis of the resource allowance deduction.

Deductibility of provincial royalties (joint venture payments) for the Syncrude project (remission order)

Taxpaying participants in the Syncrude project are permitted to deduct both the resource allowance and "joint venture payments" made to the province of Alberta in lieu of a royalty in computing income subject to tax. This is accomplished through a remission order. Under the benchmark tax system, these joint venture payments, which are profit sensitive, would not be deductible. The estimate of the tax expenditure is calculated as the value provided by this extra deduction less the reduction in the resource allowance.

Deductibility of royalties paid to Indian bands

Royalties and lease rentals paid to Indian bands in respect of oil and gas and mining activities on Indian reservations are considered to be Crown charges paid to Her Majesty in Right of Canada or of a province in trust to the Indian band. Unlike non-deductible Crown charges, amounts paid to the benefit of an Indian band are generally deductible for federal income tax purposes. In addition to the deductible Crown charges, a resource allowance is earned on the resource profits net of the deductible Crown charges.

The amounts paid to the Government of Canada in the form of mining and oil and gas royalties/lease rentals paid to Indian bands are provided below:

Oil and gas and mining royalties/lease rentals paid to Indian bands

	1993-94	1994-95	1995-96	1996-97	1997-98
			($ millions)		
Oil and gas	59.0	76.0	58.0	92.0	89.0
Mining	0.6	0.7	0.5	1.0	2.0

Source: Department of Indian Affairs and Northern Development.

Non-resident-owned investment corporation refund

A non-resident-owned investment corporation must pay income tax at a rate of 25 per cent. However, except for capital gains realized on taxable Canadian property, this tax is refundable when the surplus is distributed as taxable dividends to the shareholders, and the applicable rate of withholding tax then applies. The refund is designed to relieve the dividends paid to non-residents from double taxation that would otherwise result. The corporation is essentially treated as a conduit for the flow-through of income. The amounts reported estimate the tax revenues that would be generated if the non-resident-owned investment corporation refund was not available.

Investment corporation deduction

Investment income is taxed at the corporation level and in the hands of the individual who receives it as dividend payments. In order to achieve a certain degree of integration between the

personal and corporate tax systems, the current rules allow an investment corporation to deduct from its Part I tax otherwise payable 20 per cent of the amount by which its taxable income exceeds its taxed capital gains.

This measure constitutes a tax expenditure because it allows a public corporation that qualifies as an investment corporation to benefit from elements of the integration system which are usually available only to private corporations. The tax expenditure is estimated as the additional revenue that would have been collected by the government if investment income (except capital gains) had been taxed at the general income tax rate applicable to public corporations.

Deferral of capital gains income through various rollover provisions

The taxation of capital gains is affected by provisions that permit taxpayers to defer realization for tax purposes through various rollover provisions. Since the benchmark tax structure includes all accrued gains, this item is identified separately for information purposes. Examples include:

- the transfer of assets to a corporation or partnership in consideration for share capital or a partnership interest;
- amalgamations of taxable Canadian corporations;
- the winding-up of a subsidiary corporation into its parent corporation; and
- share-for-share exchanges.

The 1994 budget made changes that curtail the use of various rollover provisions in certain reorganizations.

No data are available.

Deduction for intangible assets

Three-quarters of eligible capital expenditures on intangible assets are added to the cumulative eligible capital of a taxpayer. A deduction of up to 7 per cent of cumulative eligible capital at the end of the year is allowed. Examples of intangible assets include goodwill, customer lists and franchises.

The deduction for intangible assets could give rise to positive or negative tax expenditure estimates depending on the actual rate of depreciation of these assets relative to the amount that is permitted for tax purposes.

No data are available.

Tax exemption on income of foreign affiliates of Canadian corporations

The Canadian system for taxing the income of foreign affiliates of Canadian shareholders or the dividend income of the Canadian shareholders derived from foreign affiliates is based on the objectives of encouraging international competitiveness, protecting the tax base and eliminating double taxation.

Where the foreign affiliate earns active business income, Canada defers any recognition of that income until it is paid to the Canadian shareholders as a dividend on shares of the affiliate. In cases where the business income has been earned in a country with which Canada has a double taxation treaty, the dividend paid out of that income to Canadian corporate shareholders is not subject to additional Canadian tax. Where the business income is earned in non-treaty countries, the dividend is taxed in Canada but a tax deduction is provided to Canadian corporate shareholders based on the underlying foreign tax paid.

Where the foreign affiliate earns passive income and the affiliate is a controlled foreign affiliate of a person resident in Canada, the passive income is taxed in the Canadian shareholder's hands on an accrual basis. The Canadian shareholder can deduct taxes paid in the foreign jurisdiction in determining net additional Canadian tax liability. When the income earned in the foreign affiliate is actually paid to the shareholder in the form of a dividend, a deduction from income subject to tax is provided to the extent that the income was included in income subject to tax in a previous year.

Questions arise as to what should be the appropriate benchmark system to measure the value of the tax expenditure, if any, in this case. Basically, three different benchmarks could be contemplated:

- **Canada should tax only Canadian-source income.**
  This is the territorial approach. Under this approach, foreign subsidiaries of Canadian companies would face the same tax burden on foreign-sourced business income as locally owned enterprises in the foreign jurisdiction. This approach is consistent with the concept of capital-import neutrality. Capital-import neutrality results when the shareholders of subsidiaries do not face additional taxes in Canada with respect to the foreign business income earned by their subsidiaries. This is the effect of Canada's decision not to tax dividends arising from affiliates in countries with which Canada has entered into a double taxation agreement as a way to relieve double taxation. If this exempt dividend approach were to be considered as the benchmark, then no preference would be associated with the foreign dividend exemption.

- **Income earned by a foreign affiliate should be taxable in Canada when dividends are paid to the Canadian shareholder and double taxation alleviated with a foreign tax credit.**
  This is the approach used by a number of countries since it allows for additional taxes to be collected in the country of residence of the shareholder of a foreign affiliate at the time a dividend is paid to the shareholder by the affiliate out of foreign business income. These additional taxes would be levied when domestic tax payable exceeds the amount of foreign taxes paid both on the dividend itself and on the underlying foreign corporate profits out of which the dividend was paid. In Canada, dividends from foreign affiliates that do not qualify as exempt dividends are taxed on this basis. If this were to be considered the benchmark system, then the exempt dividend system would provide a preference measured as the additional tax, net of the foreign tax credit, that would have been payable had the dividend been taxable in Canada.
- **Income earned by foreign affiliates should be taxable in Canada as it accrues to the Canadian shareholder (i.e. on a current basis).**
  This system is consistent with the concept of capital-export neutrality, which states that income of foreign affiliates should be subject to the same tax in the hands of its shareholders on a current basis regardless of whether the income is earned domestically or in a foreign affiliate. Certain passive income earned by controlled foreign affiliates is taxable on this basis in Canada. If this system was to be viewed as the benchmark, both the exempt dividend and the foreign tax credit approaches would be said to provide a preference measured as the deferral of incremental Canadian tax from the time the income is earned until the time the dividend is paid out.

Each of these three possible benchmarks has a policy justification. Data required to compute the amount of tax preference associated with any of the benchmarks are currently unavailable.

Chapter 6

Description of the Goods and Services Tax Provisions

Since the goods and services tax (GST) is levied at all points in the production and distribution chain, the value-added nature of the tax makes it equivalent to a retail sales tax levied on the sale of goods and services to the final consumer. Based on this equivalency, the GST base can be estimated from a Sales Tax Model constructed using data obtained from Statistics Canada's input-output tables and the National Income and Expenditure Accounts.

The data from the input-output tables are used to derive detailed expenditures by commodity for households, public sector bodies and exempt businesses. The personal expenditure categories of the input-output tables, along with the investment categories for residential construction and real estate commissions, are used to derive commodity expenditures for households. The commodity expenditures of public sector bodies are derived from certain personal expenditure categories, current government expenditure categories and appropriate investment categories contained in the input-output tables. (Public sector bodies include the federal government, provincial governments, municipalities, universities, school boards, public colleges, hospitals, charities and non-profit organizations.) The commodity expenditures of exempt businesses are derived from the input matrix of the input-output tables.

The commodity data described above are used to identify the impact of the GST provisions that either zero-rate or exempt certain goods and services. In some cases, modifications had to be made to the data derived from the input-output tables and the National Income and Expenditure Accounts to account for the structure of the GST. Since final input-output tables for a given year are available only four years after the fact, National Income and Expenditure Accounts data are used to project the impact of each GST provision to the relevant historical year. Expenditure data contained in the Department of Finance's Canadian Economic and Fiscal Model (CEFM) are used to project the impact of most of the GST provisions over the forecast period.

The Sales Tax Model is not the sole source of the estimated tax expenditures associated with the GST. In some cases, actual data from Revenue Canada were used for the tax expenditure estimates. In other cases, estimates were derived from entirely different sources. This chapter describes the various GST expenditure estimates and how they were derived.

Zero-Rated Goods and Services

Basic groceries

Basic groceries, which include the majority of foodstuffs for preparation and consumption at home, are zero-rated under the GST. However, the tax is charged on certain goods such as soft drinks, candies and confections, and alcoholic beverages.

The cost of the tax expenditure can be estimated using the Sales Tax Model by identifying commodities purchased by final consumers and public sector bodies which are currently not subject to tax. The majority of these purchases are contained in Statistics Canada's personal expenditure category "Food and Non-Alcoholic Beverages."

Prescription drugs

Drugs that are controlled substances for which a prescription is required are zero-rated. This provision also includes other drugs that have been prescribed by a recognized health care practitioner. The associated dispensing fee is also zero-rated. However, this provision excludes those items labelled or supplied for veterinary use.

The estimate is derived using the Sales Tax Model. However, an adjustment is made to reflect the fact that the input-output commodity "Pharmaceuticals" includes both prescription and non-prescription medicine. The ratio used to separate these two categories of medicine is based on information provided by Statistics Canada.

Medical devices

A wide range of medical devices are zero-rated under the GST. This includes canes; crutches; wheelchairs; medical and surgical prostheses; ileostomy and colostomy devices; artificial breathing apparatus; hearing and speaking aids; prescription eyeglasses and contact lenses; various diabetic supplies; and selected devices for the blind and for the hearing or speech impaired. In some instances, a device qualifies for tax-free status only if prescribed by a recognized health care practitioner.

The estimate is obtained using the Sales Tax Model. The zero-rated medical devices are found in the input-output commodities "Personal Medical Goods," "Medical and Dental Equipment and Supplies," and "Ophthalmic Goods." An adjustment is made to reflect the fact that the input-output commodities "Personal Medical Goods" and "Ophthalmic Goods" include expenditures made by final consumers which are not zero-rated under the medical devices provision. The ratio used to separate the zero-rated from the non-zero-rated expenditures is based on information provided by Statistics Canada.

Agricultural and fish products and purchases

Instead of taxing sales and providing input tax credits at early stages in the food production-distribution chain, certain agricultural and fish products are zero-rated all through the chain. A prescribed list of such supplies includes farm livestock, poultry, bees, grains and seeds for planting or feed, hops, barley, flax seed, straw, sugar cane or beets, etc. In addition, prescribed sales and purchases of major types of agricultural and fishing equipment are zero-rated.

The main effect of this provision is on the cash-flow position of taxpayers. For example, in the normal operation of the GST, farmers would pay the GST on taxable purchases and would claim a corresponding input tax credit at the end of their tax period. However, in the case of prescribed

zero-rated supplies, the farmer does not pay the GST and so does not have to wait to claim an input tax credit. Consequently, the cash-flow position of the farmer is improved. At the same time, however, the suppliers lose the benefit of holding the GST on these purchases until the end of their tax period. Since the aggregate tax liability of these taxpayers remains unchanged, the revenue implications of this measure are small.

Certain zero-rated purchases made by exporters

Certain supplies of goods and services delivered in Canada but subsequently exported are zero-rated. These include:

- the supply of goods to a recipient who intends to export them, provided they are not excisable goods (spirits, beer or tobacco) and the goods are not further processed or modified in Canada by the recipient;
- the supply of excisable goods to a recipient who, in turn, exports the goods in bond;
- supplies of natural gas made to a person who is exporting the gas by pipeline and not further processing or using the gas in Canada before its exportation other than as fuel or compressor gas to transport the gas; and
- goods sold to duty-free shops licensed as such under the *Customs Act*.

As with agricultural and fish products, this provision has only cash-flow implications. Again, the impact of this measure on tax revenues is small.

Non-taxable importations

Certain importations are tax-free under the GST. These importations include:

- goods, other than books and periodicals, valued at not more than $20 and mailed to residents of Canada from other countries;
- duty-free personal importations such as goods valued at not more than $500 and imported by Canadians who have been outside the country for more than seven days (the limit was $300 prior to June 13, 1995); and
- goods imported by foreign diplomats.

No data are available.

Zero-rated financial services

Financial services provided to non-residents are generally zero-rated. However, there are certain exceptions (e.g. financial services that relate to debt arising from deposits in Canada, real property situated in Canada, goods purchased for use primarily in Canada, services performed primarily in Canada).

The zero-rating provisions enable Canadian financial institutions that generate significant amounts of revenue through international activities to remain competitive in global markets.

Tax-Exempt Goods and Services

Residential and other personal-use real property

Certain real property transactions are exempt under the GST. These include sales of used residential property, sales of personal-use real property by an individual or a personal trust, and the sale of farmland to a family member who is acquiring the property for personal use.

Rentals of a residential complex (such as a house) or a residential unit (such as an apartment) for a period of at least a month are tax exempt. Short-term accommodation is also exempt where the charge for the accommodation is not more than $20 per day.

The estimate is derived using the Sales Tax Model based on the GST being applied to the input-output commodity “cash rent,” and incorporates the loss of the GST currently paid on business inputs purchased by the landlord. In addition, the estimate captures the GST being applied to certain consumer expenditures on the commodity “other rent” which represents exempt purchases of parking privileges associated with rental accommodation.

Health care services

Health care services are exempt under the GST. These services include the following categories:

- institutional health care services provided in a health care facility. These include accommodation, meals provided with accommodation, and rentals of medical equipment to patients or residents of the facility. However, it excludes meals served in a cafeteria, parking charges, or haircuts for which a separate fee is charged;
- services provided by certain health care practitioners whose profession is regulated by the governments of at least five provinces. This category includes nursing, dental, optometric, chiropractic, physiotherapy, occupational therapy, speech therapy, chiropodic, podiatric, osteopathic, audiological and psychological services; and
- services covered by a provincial health insurance plan. Most of these services are already covered by the previous two provisions.

All exempt services that are covered by provincial health insurance plans are included in the benchmark because, under the Constitution, the GST does not apply to purchases made by provincial governments. Thus, the only cost from this provision involves health services purchased by final consumers. The estimates for this provision are derived from the Sales Tax Model.

Education services (tuition)

The GST provides an exemption for most educational services. The exemption includes tuition fees paid for courses provided primarily for elementary or secondary school students; courses leading to credits towards a diploma or degree awarded by a recognized school authority, university or college; and certain other types of training for a trade or vocation. In addition, the exemption covers meals supplied to elementary or secondary students as well as most meal plans at a university or public college.

The estimate is derived from the revenues that would be collected if tuition fees were taxed and input tax credits were allowed for taxable purchases. The estimate takes into account the fact that universities and public colleges currently receive a rebate of 67 per cent of the tax that they pay on their purchases.

The estimate is derived from the Sales Tax Model based on the input-output commodity "Education Services" augmented by data contained in Statistics Canada's *Education Quarterly Review*.

Child care and personal services

Certain child and personal care services are exempt under the GST. The exemption covers the following:

- child care services provided for periods of less than 24 hours to children under 14 years of age; and
- certain personal care services including supplies of care and supervision to residents of an institution, as well as accommodation where it is provided for children or disabled or underprivileged persons.

The estimate is derived using the Sales Tax Model based on the input-output commodity "Personal Services, including Child Care" contained in the final demand category "Domestic and Child Care Services." The estimate reported here does not account for day care that might be paid by governments, or day care provided by a non-profit organization. However, the impact of these exclusions on the overall estimate is unclear since provincial expenditures would not be subject to tax and the remaining expenditures would be eligible for partial rebates if taxed.

Legal aid services

Legal services provided under a provincially authorized legal aid program are exempt under the GST. This includes payments by the client in respect of the legal aid services and payments by a legal aid society to a private lawyer for legal services.

There are two ways in which the tax is relieved:

- legal aid services delivered directly by the Crown or a Crown agency (as is the case in Nova Scotia, Newfoundland, Prince Edward Island, Quebec, Manitoba and Saskatchewan) are exempt; and

- legal aid services provided by private practitioners to a legal aid plan administrator are taxable. However, the person responsible for the legal aid plan is entitled to a rebate of 100 per cent of any tax paid on the supply.

Revenue Canada supplied the data related to the rebates provided to legal aid plans in the provinces of New Brunswick, Ontario, Alberta and British Columbia. To account for the other provinces where the service is explicitly exempt, provincial economic accounts data are used. Specifically, it is assumed that the value of legal aid services relative to the total expenditures contained in the provincial economic account category “Personal Business” in the tax-exempt provinces would be the same as in those provinces where a rebate is provided.

The projected expenditure estimate is based on the growth in consumption obtained from the CEFM.

Ferry, road and bridge tolls

International ferry services are treated as zero-rated like other international transportation services. Other ferry, road and bridge tolls are GST exempt.

The estimate is derived using the Sales Tax Model based on the expenditures of final consumers on the commodity “Highway and Bridge Maintenance.”

Municipal transit

A municipal transit service is defined as a public passenger transportation service provided by a transit authority whose services are at least 90 per cent within a particular municipality and its surrounding areas. These municipal transit services are exempt under the GST.

The estimate is derived using the Sales Tax Model.

Exemption for small businesses

Businesses or individuals with annual revenues of $30,000 or less from taxable and zero-rated transactions may elect to be exempt under the GST. Such firms would not have to charge tax on their sales and would not be able to claim input tax credits on their business purchases.

The starting point in deriving the estimate is gross sales data for 1990 obtained from personal and corporate income tax information. From this data, one can estimate that the total sales from firms with annual sales of less than $30,000 accounts for approximately 0.5 per cent of all sales in the Canadian economy. This ratio can then be applied to the total gross GST collections to approximate the revenues that would arise from eliminating the small business threshold.

The projected expenditure estimate is based on the growth in nominal gross domestic product (GDP) obtained from the CEFM.

Quick method accounting

Small businesses registered under the GST are eligible to elect to account for GST using quick method accounting. Under the scheme, businesses do not have to keep track of the tax paid on most of their inputs. Instead, these firms remit a prescribed percentage of the GST that they collect on their sales. The remaining GST collected is kept by the firm in lieu of the unaccounted input tax credits. The firm is eligible to claim an input tax credit for the tax paid on capital goods.

The estimate is derived from micro-statistical data for 1991 supplied by Statistics Canada. The take-up rate of this provision for eligible small businesses is about 22 per cent. The estimate for subsequent historical years is derived by projecting the 1991 estimate based on information from Revenue Canada regarding the growth in total input tax credits claimed.

The projected expenditure estimate is based on the growth in nominal GDP obtained from the CEFM.

Water and basic garbage collection services

Water and basic garbage collection services are exempt under the GST. Charges levied for water and basic garbage collection services are captured in the commodity "Water, Waste Disposal and Other Utilities" contained in the input-output tables. The estimate is derived from the Sales Tax Model.

Domestic financial services

Financial services are defined as including services relating to financial intermediation, market intermediation and risk pooling. However, in many cases, the price of a financial service is implicit. For example, when banks provide lending and deposit-taking services, the banks' fees for these services are the spread between interest rates received from borrowers and the interest paid to depositors. The exact price associated with each financial transaction is difficult to determine and, therefore, it is difficult to apply the GST to the sale of the service. As a result, most financial services provided to residents of Canada are exempt under the GST.

Members of a "closely related group" (if there is at least 90-per-cent cross-ownership of voting shares between them) where one of the members is a "listed financial institution" could jointly elect to treat most supplies between them as tax-exempt financial services. The purpose of this election is to recognize that a closely related corporate group can be viewed as a single entity with respect to intragroup transactions.

No data are available.

Certain supplies made by non-profit organizations

Supplies that are GST-exempt when made by non-profit organizations include recreational services provided primarily to children age 14 and under and individuals who are underprivileged or have a disability; supplies of food, beverages and lodging to relieve poverty or distress; and certain amateur performances.

No data are available.

Tax Rebates

Rebates for book purchases made by qualifying institutions

On October 23, 1996, the Minister of Finance announced that a 100-per-cent GST rebate would be provided on all book purchases made by public libraries, schools, universities, public colleges, municipalities, public hospitals, and qualifying charities and non-profit organizations.

The initial expenditure estimate for 1997 is the estimated annual cost of implementing this provision. The projected expenditure estimate is based on appropriate expenditure data obtained from the CEFM.

Housing rebates

Purchasers of newly constructed residential dwellings and substantially renovated houses are eligible for a rebate of the GST paid if the purchaser is acquiring the dwelling as a primary place of residence. For houses priced at or below $350,000, the rebate is 36 per cent of the total GST paid to a maximum of $8,750. The rebate is phased out for houses priced between $350,000 and $450,000.

The estimate for historical years is obtained from Statistics Canada's National Income and Expenditure Accounts. The projected expenditure estimate is based on the growth in investment in new residential construction obtained from the CEFM.

Rebates for foreign visitors on accommodation

Non-residents visiting Canada are entitled to a rebate for the GST paid on most goods and short-term accommodation. Specifically, the rebate covers the following where the tax paid is at least $20:

- goods for use primarily outside Canada, excluding excisable goods such as alcoholic beverages and tobacco products, provided the goods are exported within 60 days of purchase; and
- the tax paid on short-term lodging, but not including meals, where the period of stay is less than one month.

However, goods for use outside Canada are essentially the same as other exported goods and should be considered as part of the benchmark. Thus, the cost of this provision is only the rebate associated with short-term accommodation.

Revenue Canada has some administrative data related to rebates paid on short-term accommodation to foreign visitors. However, this data only partially captures the provision's associated tax expenditure, since it is not possible to identify the value of rebates that are conferred to travel operators and which are included in the business's input tax credit. The estimate of the tax expenditure for short-term accommodation is based upon Revenue Canada administrative data, supplemented with additional data on foreign visitors provided by Statistics Canada.

Rebates for municipalities

Recognized municipalities are entitled to a rebate of 57.14 per cent of the GST paid on their purchases used in the course of supplying exempt municipal services.

The estimate for historical years is based on data from Revenue Canada. Since the value of the tax expenditure is influenced by provincial budgetary decisions, the projected value of the tax expenditure for the relevant years is simply the value estimated for 1997.

Rebates for hospitals

Public hospitals are eligible for a rebate of 83 per cent of the GST paid on purchases related to their supply of exempt services.

The estimate for historical years is based on data from Revenue Canada. Since the value of the tax expenditure is influenced by provincial budgetary decisions, the projected value of the tax expenditure for the relevant years is simply the value estimated for 1997.

Rebates for schools

Elementary and secondary schools operating on a not-for-profit basis are eligible for a rebate of 68 per cent of the GST paid on purchases related to their supply of exempt services.

The estimate for historical years is based on data from Revenue Canada. Since the value of the tax expenditure is influenced by provincial budgetary decisions, the projected value of the tax expenditure for the relevant years is simply the value estimated for 1997.

Rebates for universities

Recognized degree-granting universities operating on a not-for-profit basis are eligible for a rebate of 67 per cent of the GST paid on purchases related to their supply of exempt services.

The estimate for historical years is based on data from Revenue Canada. Since the value of the tax expenditure is influenced by provincial budgetary decisions, the projected value of the tax expenditure for the relevant years is simply the value estimated for 1997.

Rebates for colleges

Public colleges which are funded by a government or municipality and whose primary purpose is to provide vocational, technical or general education are eligible for a rebate of 67 per cent of the GST paid on purchases related to their supply of exempt services.

The estimate for historical years is based on data from Revenue Canada. Since the value of the tax expenditure is influenced by provincial budgetary decisions, the projected value of the tax expenditure for the relevant years is simply the value estimated for 1997.

Rebates for charities

Charities registered under the *Income Tax Act* are eligible for a rebate of 50 per cent of the GST paid on purchases related to their supply of exempt services.

The estimate for historical years is based on data from Revenue Canada. Since the expenditures of charities are captured in Statistics Canada's definition of personal expenditures, the projected estimate is based on the growth in consumer expenditures obtained from the CEFM.

Rebates for non-profit organizations

The organizations eligible for this rebate are government-funded non-profit organizations. They include registered amateur athletic associations and organizations operating a facility or part thereof to provide nursing home intermediate care or residential care that receive at least 40 per cent of their funding from governments, municipalities or Indian bands. These organizations are eligible for a rebate of 50 per cent of the GST paid on purchases related to their supply of exempt services.

The estimate for historical years is based on data from Revenue Canada. Since the expenditures of non-profit organizations are captured in Statistics Canada's definition of personal expenditures, the projected estimate is based on the growth in consumer expenditures obtained from the CEFM.

Tax Credits

Special credit for certified institutions

A special credit was provided in the period from January 1, 1991 to the end of 1995 to certified institutions that employed mentally or physically disabled individuals in the manufacturing of goods. These institutions were treated in the same manner as other businesses under the GST. However, they received a special credit calculated on the basis of 100 per cent of the GST collected from sales of manufactured goods in 1991, 75 per cent in 1992, 50 per cent in 1993 and 25 per cent in both 1994 and 1995.

No data are available.

The GST credit

When the GST was introduced, a GST credit was established to ensure that families with annual incomes below $30,000 would be better off under the new sales tax regime. The amount of the GST credit depends upon family size and income. Currently, the basic adult credit is $199. Families with children 18 years and younger receive a basic child credit of $105 for each child. However, single parents can claim a full adult credit of $199 for one dependent child. In addition to their basic credit, single adults (including single parents) are eligible for an additional credit of up to $105. The value of the credit is reduced for families with incomes of over $25,921. Both the credit amounts and the income threshold are adjusted annually to increases in the consumer price index in excess of 3 per cent.

The estimate for historical years is based on data from Revenue Canada. The projected expenditure estimate is obtained from the Department of Finance's fiscal forecast.

Memorandum Items

Meals and entertainment expenses

In the normal operation of the GST, registrants are allowed to claim full input tax credits for the tax paid on their purchases. However, in the case of the tax paid on meals, beverages and entertainment expenses, the registrant is allowed to recover only 50 per cent of the GST paid as an input tax credit. (Prior to February 1994, the input tax credit for business meals and expenses was 80 per cent.) There is no input tax credit allowed for the GST paid on membership fees or dues in any club whose main purpose is to provide dining, recreational or sporting facilities.

The estimate is based on the cost of the meals and entertainment tax expenditures contained in the personal and corporate income tax expenditure tables. These figures are first grossed up to arrive at the total meals and entertainment expenses in the entire economy using the marginal federal income tax rates by sector. Then, 15 per cent is removed to account for expenses incurred in GST-exempt activities since they are ineligible for any input tax credits. The cost of this provision is equal to the above net expenses multiplied by 7 per cent.

Rebates to employees and partners

A rebate is available to certain employees of a GST registrant for the GST paid on those expenses that are deductible in computing the employee's income from employment for income tax purposes. For example, an employee is allowed to claim a rebate equal to 7/107ths of the capital cost allowance on an automobile, aircraft or musical instrument that is used in his or her employment and on which GST is payable. Also, the GST rebate is available to an individual who is a member of a GST-registered partnership in respect of expenses incurred outside the partnership that are deducted in computing the member's income from the partnership for the purposes of the *Income Tax Act*.

The estimate for historical years is based on data from Revenue Canada. The projected expenditure estimate is based on the growth in nominal GDP obtained from the CEFM.

Sales of personal-use real property

The sale of personal-use real property by an individual or trust (all of the beneficiaries of which are individuals) is exempt under the GST. Examples include the sale of used owner-occupied homes and country properties kept for personal use. However, the exemption does not include real property that is sold in the course of business.

No data are available.